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In the Supreme Court of the United States

OCTOBER TERM, 1989

UNITED STATES OF AMERICA, PETITIONER

v.

ENERGY RESOURCES CO., INC.

UNITED STATES OF AMERICA, PETITIONER

v.

NEWPORT OFFSHORE, LTD.

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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QUESTION PRESENTED

Whether a bankruptcy court may require the Internal Revenue Service to apply tax payments made by a corporate debtor pursuant to its Chapter 11 plan of reorganization first to the trust fund portion of the corporation's tax liability, thereby relieving the corporation's responsible persons of their separate liability for those taxes.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	2
Statutes involved	2
Statement	3
Reasons for granting the petition	11
Conclusion	22
Appendix A	1a
Appendix B	24a
Appendix C	27a
Appendix D	31a
Appendix E	42a
Appendix F	51a
Appendix G	52a

TABLE OF AUTHORITIES

Cases:

Amos v. *Commissioner*, 47 T.C. 65 (1966)	16
Avildsen Tools & Machines, Inc., In re, 40 Bankr. 253 (N.D. Ill. 1984), aff'd, 794 F.2d 1248 (7th Cir. 1986)	14, 16
B & P Enterprises, Inc., In re, 67 Bankr. 179 (Bankr. W.D. Tenn. 1986)	15
Bird v. *Carl's Grocery Co. (In re NWFX, Inc.)*, 864 F.2d 593 (8th Cir. 1989)	19
DuCharmes & Co. v. *Michigan*, 852 F.2d 194 (6th Cir. 1988)	12
Frank Meador Buick, Inc., In re, No. 88-349-R (W.D. Va. Mar. 16, 1989), rev'g 85 Bankr. 392 (Bankr. W.D. Va. 1988), appeal pending, No. 89-2954 (4th Cir.)	14
Frost, In re, 47 Bankr. 961 (D. Kan. 1985)	14
Hineline v. *Household Fin. Corp.*, 72 Bankr. 642 (N.D. Ohio 1987)	15
Hubler Rentals, In re, 79-2 U.S. Tax Cas. (CCH) ¶ 9621 (E.D. Pa. 1979)	15
Intermarket, Inc., In re, 93 Bankr. 70 (D. Md. 1988)	14

Cases – Continued: Page

Jehan-Das, Inc., In re, 91 Bankr. 542 (Bankr. W.D. Mo. 1988), aff'd, No. 89-3030-CV-S-2 (W.D. Mo. May 8, 1989), appeal pending, No. 89-1859 (8th Cir.) 14-15
Lifescape, Inc., In re, 54 Bankr. 526 (Bankr. D. Colo. 1985) 15
McCom Communications, Inc., In re, 76 Bankr. 180 (N.D. Ala. 1987) 14
Mister Marvins, Inc., In re, 48 Bankr. 279 (E.D. Mich. 1984) 14
Muntwyler v. *United States*, 703 F.2d 1030 (7th Cir. 1983) 16
O'Dell v. *United States*, 326 F.2d 451 (10th Cir. 1964) 16
Obie Elie Wrecking Co., In re, 35 Bankr. 114 (Bankr. N.D. Ohio 1983) 15
Official Committee of Equity Security Holders v. *Mabey*, 832 F.2d 299 (4th Cir. 1987) 19
Professional Technical Services, Inc., In re, 94 Bankr. 578 (E.D. Mo. 1988) 14
Puget Sound Plywood, Inc., In re, 89-1 U.S. Tax. Cas. (CCH) ¶ 9240 (Bankr. W.D. Wash. 1989) 14
R.L. Inge Development Corp., In re, 78 Bankr. 793 (Bankr. E.D. Va. 1987) 15
Ribs-R-Us, Inc., In re, 828 F.2d 199 (3d Cir. 1987) 8, 9, 12, 13, 16
Shoup's Food Service, Inc., In re, 96 Bankr. 767 (Bankr. W.D. Mich. 1988) 14
Slodov v. *United States*, 436 U.S. 238 (1978) 17
Tam Speciality Co., In re, 85-2 U.S. Tax Cas. (CCH) ¶ 9758 (Bankr. N.D. Cal. 1985) 15
Timbers of Inwood Forest Assocs., Ltd., In re, 808 F.2d 363 (5th Cir. 1987), aff'd, 108 S. Ct. 626 (1988) 21
Tom LeDuc Enterprises, Inc., In re, 47 Bankr. 900 (W.D. Mo. 1984) 15
Technical Knockout Graphics, Inc., In re, 833 F.2d 797 (9th Cir. 1987) 13
United States v. *A & B Heating & Air Conditioning, Inc.*, 823 F.2d 462 (11th Cir. 1987), vacated, 108 S. Ct. 1724 (1988), on remand, 861 F.2d 1538 (11th Cir. 1988) 14
United States v. *Sotelo*, 436 U.S. 268 (1978) 17

Cases – Continued: Page

United States v. *Sutton*, 786 F.2d 1305 (5th Cir. 1986) 19
USLIFE Title Insurance Co. v. *Harbison*, 784 F.2d 1238 (5th Cir. 1986) 4
Vermont Fiberglass, Inc., In re, 88 Bankr. 41 (D. Vt. 1988) 14
Vincent-McCall Co., In re, 68-2 U.S. Tax Cas. (CCH) ¶ 9591 (E.D. Wis. 1986) 14

Statutes:

All Writs Act, 28 U.S.C. 1651 18
Bankruptcy Code, 11 U.S.C. 101 *et seq.*:
11 U.S.C. 105 ..... 9, 18
11 U.S.C. 105 (Supp. V 1987) 2, 19
11 U.S.C. 507 (1982 & Supp. V 1987) 2
11 U.S.C. 507(a) (1982 & Supp. V 1987) 2, 19
11 U.S.C. 507(a)(6) 4
11 U.S.C. 507(a)(7) (Supp. V 1987) 2, 4
11 U.S.C. 507(a)(7)(C) (Supp. V 1987) 3, 20
11 U.S.C. 523(a)(1) (1982 & Supp. V 1987) 20
11 U.S.C. 1101 *et seq.* (Ch. 11) ..... *passim*
11 U.S.C. 1129 (1982 & Supp. V 1987) 3, 10
11 U.S.C. 1129(a)(9)(C) (Supp. V 1987) 3, 4
Internal Revenue Code, (26 U.S.C.):
§ 31(a) 17
§ 3102 4
§ 3402 4
§ 6672 ..... 4, 11, 13, 16, 17, 18, 20, 21
§ 7501 4

Miscellaneous:

H.R. Rep. No. 595, 95th Cong., 1st Sess. (1977) 18
Rev. Rul. 58-239, 1958-1 C.B. 94 15
Rev. Rul. 73-305, 1973-2 C.B. 43 15
Rev. Rul. 79-284, 1979-2 C.B. 83 15
S. Rep. No. 989, 95th Cong., 2d Sess. (1978) 18, 19

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PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

The Solicitor General, on behalf of the United States of America,[1] petitions for writs of certiorari to review the judgments of the United States Court of Appeals for the First Circuit in these cases.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-23a) is reported at 871 F.2d 223. In the *Energy Resources* case the opinion of the district court (App.,

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[1] The Internal Revenue Service was erroneously named as the governmental party in the Energy Resources litigation. Accordingly, we have substituted the United States as the proper party in the caption of *Energy Resources*.

infra, 24a-26a) is unreported; the opinion of the bankruptcy court (App., *infra*, 31a-41a) is reported at 59 Bankr. 702. In the *Newport Offshore* case, the oral opinion of the district court (App., *infra*, 27a-30a) is unreported; the opinion of the bankruptcy court (App., *infra*, 42a-50a) is reported at 75 Bankr. 919.

JURISDICTION

The judgments of the court of appeals (App., *infra*, 51a-52a) were entered on March 31, 1989. On June 19, 1989, Justice Brennan extended the time to petition for writs of certiorari to and including August 8, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

Section 105 of the Bankruptcy Code, 11 U.S.C. 105 (Supp. V 1987), provides in pertinent part:

Power of court

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.

* * * * *

Section 507 of the Bankruptcy Code, 11 U.S.C. 507 (Supp. V 1987), provides in pertinent part:

Priorities

(a) The following expenses and claims have priority in the following order:

* * * * *

(7) Seventh, allowed unsecured claims of governmental units, only to the extent that such claims are for—

* * * * *

(C) a tax required to be collected or withheld and for which the debtor is liable in whatever capacity;

* * * * *

Section 1129 of the Bankruptcy Code, 11 U.S.C. 1129 (Supp. V 1987), provides in pertinent part:

Confirmation of plan

(a) The court shall confirm a plan only if all of the following requirements are met:

* * * * *

(9) Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that—

* * * * *

(C) with respect to a claim of a kind specified in section 507(a)(7) of this title, the holder of such claim will receive on account of such claim deferred cash payments, over a period not exceeding six years after the date of assessment of such claim, of a value, as of the effective date of the plan, equal to the allowed amount of such claim.

* * * * *

STATEMENT

These two cases were consolidated for purposes of argument and decision in the court of appeals. Both cases involve corporations that are in reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*) and that owe the government both trust fund and non-trust fund taxes. Trust fund taxes are those taxes withheld from the wages of employees and held by the em-

ployer in trust for the government under Section 7501 of the Internal Revenue Code (26 U.S.C.).[2] If the persons responsible to collect, account for, and pay over trust fund taxes to the government willfully fail to do so, they each become personally liable under 26 U.S.C. 6672 for a penalty in the full amount of the unpaid trust fund taxes. Since the government collects the amount of the unpaid trust fund taxes only once (see *USLIFE Title Insurance Co.* v. *Harbison*, 784 F.2d 1238, 1243 (5th Cir. 1986)), the Section 6672 liability of each "responsible person" is reduced to the extent that the trust fund taxes are paid by the corporation.

1. In January 1983, respondent Energy Resources Company and its affiliates filed petitions for reorganization under Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*). At that time, respondent owed about $1 million in taxes, most of which were trust fund taxes. App., *infra*, 5a. Under Chapter 11 as in effect at that time, these taxes were entitled to a "sixth priority" (11 U.S.C. 507(a)(6)).[3] Chapter 11 requires as a condition of confirmation that a reorganization plan provide for the payment of all priority tax liabilities over a period not to exceed six years (11 U.S.C. 1129(a)(9)(C)).

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[2] Sections 3102 and 3402 of the Internal Revenue Code (26 U.S.C.) require employers to deduct from wages certain amounts for the employees' income taxes and for the employees' portion of social security taxes. These amounts are to be "held * * * in trust" for the United States and later paid over to the government by the employer (26 U.S.C. 7501). Other corporate tax liabilities that are not withheld from employees' wages, such as corporate income tax and the employer's share of social security taxes, are referred to as "non-trust fund" taxes.

[3] Due to a 1984 amendment that added a new category of priority claims, priority federal tax claims are now seventh priority claims. See 11 U.S.C. 507(a)(7) (Supp. IV 1986).

a. The bankruptcy court confirmed Energy Resources' third amended plan of reorganization. That plan provided that most of the debtor's assets would be transferred to the ERCO Liquidation Trust, and thereafter liquidated under the supervision of a liquidation trustee for payment to creditors of the estate. The plan provided for the payment of pre-petition tax claims, with interest, from the liquidation trust in four annual installments beginning on the anniversary of the confirmation date, October 1, 1984. The trustee could prepay the taxes at any time. App., *infra*, 5a, 32a.

On November 6, 1985, the trustee made a payment of the pre-petition federal tax claims totalling $281,517. The trustee designated "that this payment be applied to the trust fund portion of the taxes, first for the period ended June 30, 1982 with the excess, if any, applied to the trust fund portion of the taxes for the period ended September 30, 1982." App., *infra*, 33a. The Internal Revenue Service (IRS) refused to accept the trustee's designation, maintaining that it had the right to apply the payment to the corporate debtor's oustanding tax liability as it chose. The IRS informed the trustee by letter that, "[u]nless such direction of payment is given in a court order, the United States reserves the right to apply such payment[,] which is a distribution of a bankruptcy proceeding[,] to its maximum benefit." *Ibid.*

The trustee thereupon moved the bankruptcy court for an order directing the IRS to apply payments under the plan according to the trustee's designation. In his motion, the trustee argued that he was entitled to designate tax payments under the plan because the payments were "voluntary." He also contended that the designation of payments was necessary for the benefit of the bankruptcy estate. He stated that the designation enabled him to implement a settlement agreement entered into with Richard

Rosen, a former officer of the debtor, in which Rosen immediately released $14,000 to the trust, assertedly in exchange for the trustee's agreement "to cooperate in designating tax payments which would forestall personal liability assessed by the IRS against the former officers from affecting them." The trustee also asserted that the designation would not harm the IRS because the plan provided, ultimately, for payment of the tax claims in full. The IRS opposed the trustee's motion on the ground that the payment of priority taxes under a Chapter 11 plan is involuntary and therefore the IRS is permitted to apply the payment as it chooses. App., *infra*, 33a-34a.

b. The bankruptcy court granted the motion and ordered the IRS to follow the trustee's designation (App., *infra*, 31a-41a). The court stated the general rule that a taxpayer who makes a "voluntary" tax payment is entitled to designate the manner in which it is to be applied, whereas that authority rests with the IRS if the payment is "involuntary" (*id.* at 34a). Relying on several other bankruptcy court decisions, the court held that "the mere filing of a claim in a Chapter 11 proceeding and the confirmation of a plan of reorganization do not constitute sufficient judicial action to render payment made pursuant to a Chapter 11 plan involuntary" (App., *infra*, 36a), and therefore the trustee was entitled to designate how the tax payment should be applied (*id.* at 36a-40a). The court also stated that its conclusion was buttressed by the government's failure to object to confirmation of the plan, even though the plan was silent on the question of designation or the manner in which the tax payments should be applied, because it was "foreseeable" that the trustee would seek such a designation (*id.* at 40a-41a).

c. On appeal, the district court affirmed (App., *infra*, 24a-26a). The court stated that the bankruptcy court's role in confirming a plan under Chapter 11 does not make a

tax payment thereunder involuntary because the Bankruptcy Code affords debtors considerable flexibility in Chapter 11. Thus, in the district court's view, the bankruptcy "court here didn't compel the action; rather, it approved a payment which a debtor wished to make" (App., *infra*, 26a).

2. a. In the *Newport Offshore* case, respondent Newport Offshore filed a petition for reorganization under Chapter 11 on November 13, 1985, and continued operating as a debtor-in-possession. The trustee proposed a plan of reorganization under which a third party, Allied Marine Associates, agreed to pay all of respondent's pre-petition tax liability and various other debts, and to invest additional money in the corporation; in return, it would receive 85% of the shares of the new, reorganized Newport Offshore. The proposed plan provided for full payment of pre-petition priority tax claims over a period of about six years. It further provided that these payments would be applied to extinguish all "trust fund" tax debts "prior to the commencement of payment of the non-trust fund portion" of the taxes (App., *infra*, 5a). The government objected to the designation provision on the same grounds that it raised in *Energy Resources*.

b. The bankruptcy court overruled the government's objection (App., *infra*, 42a-50a). The court declined to adopt respondent's contention that tax payments under a Chapter 11 plan always may be designated by the debtor because there is no "enforced collection measure" that makes them involuntary (see *id.* at 45a-46a). Instead, the court concluded that whether a Chapter 11 debtor may designate its tax payments should be decided on a case-by-case basis according to the "totality of the facts and circumstances" (*id.* at 47a).[4] The court expressed the concern

[4] The court listed several factors that it regarded as relevant to this analysis, including: (1) the history of the debtor; (2) whether the

that, if payments of priority taxes in Chapter 11 cases were always held to be involuntary, it "would remove the initiative of [the debtor's] former principals to seek outside investors, who voluntarily inject needed cash into the estate, and would, as a consequence, either inhibit or eliminate altogether the likelihood of a viable Chapter 11 plan" (*id.* at 48a). The court concluded that the existence of third-party financing constituted "special circumstances" that justified including the trustee's requested designation provision in the plan (*ibid.*).

c. Ruling from the bench, the district court reversed and ordered the bankruptcy court to delete the designation provision from the reorganization plan (App., *infra*, 27a-30a). Relying on the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (1987), the court concluded that advancing the policy of reorganization did not require permitting the designation provision at issue, which would undermine the policy of collecting taxes (App., *infra*, 29a). The court concluded that Congress "did not ever intend that a principal stockholder of a corporation in reorganization would have the ability to negotiate in the Bankruptcy Court an exculpatory provision with respect to the trust fund taxes" (*id.* at 29a-30a).

3. On consolidated appeals, the court of appeals affirmed in the *Energy Resources* case and reversed in the *Newport Offshore* case (App., *infra*, 1a-23a). The court stated that whether payments made pursuant to a Chapter 11 reorganization plan should be characterized as "voluntary" or "involuntary" depends upon the degree of control

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IRS had taken any pre-bankruptcy collection measures; (3) the nature of the Chapter 11 plan; (4) the extent of administrative or court action; and (5) the "existence of exceptional or special circumstances warranting [the] allocation provided by the plan." App., *infra*, 47a n.7.

the bankruptcy court has over the payments at issue, and it found that a Chapter 11 proceeding exhibits some characteristics that are "voluntary" and others that are "involuntary." Recognizing the deference due the IRS's interpretation on this matter, the court declared that it accepted the view that payments made pursuant to a Chapter 11 plan are "involuntary." *Id.* at 7a-12a. The court determined, however, that this conclusion was not dispositive because it "only means * * * that the *IRS's own rules and regulations* do not *compel* it to accept the taxpayers' determinations as to how it must apply payments here at issue" (*id.* at 12a). The court then proceeded to hold that the bankruptcy courts were empowered to require the IRS to apply the tax payments first to the trust fund tax liability. The court acknowledged that this holding was inconsistent with the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, *supra*, which had been followed by two other circuits (App., *infra*, 4a).

The court of appeals viewed the governing question as (App., *infra*, 12a-13a): "Does a bankruptcy court possess the legal power to order the IRS to apply a payment in a way that runs *counter* to IRS's own internal policies?" The court listed several factors it considered significant in concluding that bankruptcy courts do have the power to override the IRS's traditional authority to apply involuntary tax payments as it chooses.

First and foremost, the court stated that "Congress has granted bankruptcy courts broad equitable powers" (App., *infra*, 13a). In particular, the court pointed to the bankruptcy court's power to " 'issue any order, process, or judgment that is necessary *or appropriate* to carry out the provisions' of the Bankruptcy Code" (*ibid.*, quoting 11 U.S.C. 105 (emphasis by the court)). As an example of when "an order allocating Chapter 11 tax payments to 'trust fund' liabilities first would seem 'appropriate,' " the

court posited the situation where the responsible officers offer to help rehabilitate the debtor by advancing funds, but "only if the court would assure them that the reorganized corporation would pay its 'trust fund' tax debts first" (App., *infra*, 13a-14a). In that situation, the court reasoned, the bankruptcy court could determine that the diminished chances that the government would collect its entire tax debt would be outweighed by the increased chances that the debtor would pay something to its general creditors (*id.* at 14a).

In the court's view, the other factors that it listed buttressed this conclusion regarding the bankruptcy court's power. The court stated that the bankruptcy courts have long had the legal power to tell creditors how to apply payments against the debtor's several debts (App., *infra*, 14a-15a) and that nothing in the Bankrutpcy Code limits the bankruptcy court's designation power when the creditor is the IRS (*id.* at 15a-16a). The court reasoned that "it makes administrative sense for the bankruptcy court to have the power to determine, in some cases, the debt allocation of Chapter 11 tax payments" because it is equipped to consider the effect of that determination on the debtor's prospects for rehabilitation and already has the power to structure the timing of tax payments within the six-year constraint of 11 U.S.C. 1129 (App., *infra*, 16a).

The court further noted that the IRS's policy of allocating payments first to non-trust fund taxes, while clearly calculated to maximize the collection of delinquent taxes, was not embodied in any statute (App., *infra*, 16a-17a). Finally, the court stated that it could "find no policy embodied in any specific statute, tax or otherwise, that either directly, or by manifesting a congressional intent, circumscribes a bankruptcy court's general powers in the respect at issue here" (*id.* at 17a). In particular, the

court stated that the strong congressional policy of ensuring the collection of trust fund taxes embodied in 26 U.S.C. 6672 would not be undermined by its decision because the designation provided for the collection of trust fund taxes first, albeit at the expense of non-trust fund taxes that would go unpaid if the reorganization failed, while the IRS's allocation postponed the collection of trust fund taxes (App., *infra*, 17a-20a).

Accordingly, the court of appeals concluded that the bankruptcy courts have the legal power to order the allocation of involuntary tax payments in Chapter 11 proceedings. The court held that the allocation question should be determined by the bankruptcy court on a case-by-case basis, subject to review under the clearly erroneous standard. App., *infra*, 21a. And the court specified the following as the appropriate inquiry (*ibid.*): "upon consideration of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, *i.e.*, increased likelihood of payment to creditors who might otherwise lose their money?" The court concluded that it was unnecessary to remand the cases, holding that the bankruptcy courts' opinions indicated that they both would have upheld the requested designations under the standard promulgated by the court of appeals (*id.* at 21a-23a).

REASONS FOR GRANTING THE PETITION

The court of appeals has erroneously decided an important and frequently recurring question of federal law, in direct confict with the decisions of other courts of appeals. The court has held that bankruptcy courts have dis-

cretion to allow a corporate debtor in Chapter 11 proceedings to designate priority federal tax payments under its reorganization plan for application first to trust fund tax liability. The effect of this decision is to sanction the use of Chapter 11 by officers of the corporate debtor to reduce or eliminate their potential personal liability for delinquent trust fund taxes and thereby undermine the separate source of collection of those taxes and the deterrent to their misuse that has been established by Congress. As a result, tax payments under Chapter 11 plans would, as a practical matter, first redound to the benefit of the corporate officers, not the government. If the plan were not successfully completed, the government would still be left with an uncollectible non-trust fund tax claim, while the corporate officers would have been relieved of their trust fund liability to the extent payments have been made. In light of the frequency with which this issue recurs, it is essential that the conflict in the circuits be resolved and that a uniform rule be established to guide the conduct of Chapter 11 proceedings.

1. The court of appeals acknowledged (App., *infra*, 4a) that the decision below directly conflicts with the Third Circuit's decision in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (1987). It similarly conflicts with the Sixth Circuit's decision in *DuCharmes & Co.* v. *Michigan*, 852 F.2d 194 (1988). In each of those cases, as here, the government objected to a proposed Chapter 11 plan that provided that payments of priority taxes were to be applied first to the trust fund portion of the outstanding tax liability. Both courts of appeals determined that tax payments made pursuant to a Chapter 11 plan are not voluntary and therefore may be allocated as the IRS determines. *In re Ribs-R-Us, Inc.*, 828 F.2d at 201-203; *DuCharmes & Co.* v. *Michigan*, 852 F.2d at 196. Pointing to the debtor's failure to produce evidence "that suggests that Congress intended by the

Bankruptcy Code to curtail the IRS's longstanding ability to use 26 U.S.C. § 6672 to provide a collateral source for collection of trust fund taxes," the Third Circuit held that "no provision of the Bankruptcy Code allows either the debtor or the bankruptcy court to direct application of payments and thereby preclude recourse by the United States against responsible parties" (*In re Ribs-R-Us, Inc.*, 828 F.2d at 203-204 & n.4). The court concluded that permitting the debtor to designate the portion of its tax liability to which payments should be allocated would be "in derogation of Congress' strong policy, reflected in section 6672, to protect the government's tax revenues by insuring an additional source from which trust fund taxes can be collected" (*id.* at 204). The Third Circuit also criticized the approach of permitting designation on a case-by-case basis, which was approved by the court of appeals below; it explained that "[a] uniform federal rule is preferable so that debtors, creditors, and the Internal Revenue Service will be able to know in advance whether the debtor can make such a designation and guide their decisions accordingly" (*id.* at 202).

The decision below is also inconsistent with the Ninth Circuit's decision in a slightly different context in *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (1987). In that case, a debtor filed a petition for relief under Chapter 11 and then, before the confirmation of its reorganization plan, filed a motion asking that it be permitted to make payments to the IRS designated for application to its trust fund tax liability. Rejecting the IRS's objection, the bankruptcy court ordered the IRS to apply any such payments according to the debtor's requested designation. The court of appeals reversed, finding that those payments would be "involuntary" and that the bankruptcy court's equitable powers do not permit it to enforce such a designation. The court explained that, once

a debtor invokes the assistance of the bankruptcy court to keep its creditors at bay by filing a Chapter 11 petition, it can no longer claim that its tax payments are voluntary, and it "is not free to abuse this system by designating its payments in a way that benefits only its responsible persons, and possibly harms other creditors, including the IRS, without the scrutiny of the court or other creditors" (833 F.2d at 803).[5]

In addition to these court of appeals decisions, the question presented here has been addressed with varying results by numerous lower courts.[6] Thus, there exists an acknowledged conflict in the circuits and considerable disarray in the lower courts on an important and frequently recurring issue. It is therefore necessary for this Court to resolve the conflict and provide a uniform rule to guide the lower courts in dealing with attempts by Chapter 11 corporate debtors to protect their officers' personal funds by designating priority tax payments for application first to trust fund tax liability.

[5] The result reached by the court below is consistent with that reached by the Eleventh Circuit in *United States* v. *A & B Heating & Air Conditioning, Inc.*, 823 F.2d 462 (1987), vacated, 108 S. Ct. 1724 (1988), on remand, 861 F.2d 1538 (1988). On the government's petition for a writ of certiorari, that decision, which upheld the bankruptcy court's discretion to order the IRS to comply with the debtor's designation, was vacated by this Court in light of the debtor's declaration that it was no longer interested in enforcement of the designation provision. The reorganization plan ultimately was amended to remove that provision.

[6] The following cases have held payment of priority taxes in bankruptcy to be subject to application as the IRS determines on the ground that the payments are involuntary: *In re Frank Meador Buick, Inc.*, No. 88-349-R (W.D. Va. Mar. 16, 1989), rev'g 85 Bankr. 392 (Bankr. W.D. Va. 1988), appeal pending, No. 89-2954 (4th Cir.); *In re Intermarket, Inc.*, 93 Bankr. 70 (D.Md. 1988); *In re Professional Technical Services, Inc.*, 94 Bankr. 578 (E.D. Mo. 1988); *In re Vermont Fiberglass, Inc.*, 88 Bankr. 41 (D. Vt. 1988); *In re McCom Communications, Inc.*, 76 Bankr. 180 (N.D. Ala. 1987); *In re Mister Marvins, Inc.*, 48 Bankr. 279 (E.D. Mich. 1984); *In re Frost*, 47 Bankr. 961 (D. Kan. 1985); *In re Avildsen Tools & Machines, Inc.*, 40 Bankr. 253 (N.D. Ill. 1984), aff'd on other grounds, 794 F.2d 1248 (7th Cir. 1986); *In re Vincent-McCall Co.*, 68-2 U.S. Tax Cas. (CCH) ¶ 9591 (E.D. Wis. 1986); *In re Puget Sound Plywood, Inc.*, 89-1 U.S. Tax Cas. (CCH) ¶ 9240 (Bankr. W.D. Wash. 1989); *In re Shoup's Food Service, Inc.*, 96 Bankr. 767 (Bankr. W.D. Mich. 1988); *In re Jehan-Das, Inc.*, 91 Bankr. 542 (Bankr. W.D. Mo. 1988), aff'd, No. 89-3030-CV-S-2 (W.D. Mo. May 8, 1989), appeal pending, No. 89-1859 (8th Cir.); *In re R.L. Inge Development Corp.*, 78 Bankr. 793 (Bankr. E.D. Va. 1987); *In re Tam Specialty Co.*, 85-2 U.S. Tax Cas. (CCH) ¶ 9758 (Bankr. N.D. Cal. 1985); *In re Obie Elie Wrecking Co.*, 35 Bankr. 114 (Bankr. N.D. Ohio 1983); *In re Hubler Rentals*, 79-2 U.S. Tax Cas. (CCH) ¶ 9621 (E.D. Pa. 1979). The following decisions have held such payments to be voluntary and thus subject to designation by the debtor or the bankruptcy court: *In re Lifescape, Inc.*, 54 Bankr. 526 (Bankr. D. Colo. 1985); *In re Tom LeDuc Enterprises, Inc.*, 47 Bankr. 900 (W.D. Mo. 1984). The following cases have held, like the court of appeals below, that allocation of payments is within the discretion of the bankruptcy court: *Hineline* v. *Household Fin. Corp.*, 72 Bankr. 642 (N.D. Ohio 1987); *In re B & P Enterprises, Inc.*, 67 Bankr. 179 (Bankr. W.D. Tenn. 1986).

2. a. The court of appeals erred in holding that the bankruptcy court has the power to direct the IRS to allocate a corporate debtor's involuntary tax payments first to the debtor's trust fund tax liability, so as to eliminate the corporate officers' personal liability for those taxes. The IRS's longstanding policy has been to permit taxpayers to designate the application of tax payments that are voluntarily made. See Rev. Rul. 79-284, 1979-2 C.B. 83, modifying Rev. Rul. 73-305, 1973-2 C.B. 43, superseding Rev. Rul. 58-239, 1958-1 C.B. 94. The IRS's policy, however, does not permit the taxpayer to designate involuntary payments which traditionally have been viewed as including payments received as a result of a levy or legal proceeding in which the government is seeking to

collect its delinquent taxes. See *Amos* v. *Commissioner*, 47 T.C. 65, 69 (1966). This policy, which has generally been approved by the courts, encourages taxpayers to make voluntary payments. See, *e.g.*, *Muntwyler* v. *United States*, 703 F.2d 1030, 1032 (7th Cir. 1983); *O'Dell* v. *United States*, 326 F.2d 451, 456 (10th Cir. 1964); *Amos* v. *Commissioner*, 47 T.C. at 69-70. In particular, when a corporation is in financial distress, this policy encourages responsible persons to resist the temptation to borrow money from the government's trust fund, *i.e.*, to pay business expenses with taxes that have been withheld from employees' wages. Instead, the officers are motivated to turn those withheld taxes over to the government in a timely fashion so that they can avoid the prospect of personal liability under 26 U.S.C. 6672. Such voluntary compliance with the trust fund structure avoids the expenditure of government resources on collection by means of administrative levy or judicial proceedings. See, *e.g.*, *In re Ribs-R-Us, Inc.*, 828 F.2d at 201-202; *In re Avildsen Tools & Machines, Inc.*, 794 F.2d 1248, 1251 (7th Cir. 1986).

The court of appeals disregarded this established framework by permitting a corporate debtor, with the approval of the bankruptcy court, to designate the application of tax payments that the court acknowledged were involuntary. This decision severely undermines the salutary policy goals that are advanced by the established differential treatment of voluntary and involuntary payments. The incentive for the debtor to make its tax payments voluntarily prior to bankruptcy is removed; despite its decision to default on its taxes and instead to pay them only as required by statute as a condition of confirmation of its reorganization plan, the debtor retains the power to designate its payments as if it had paid the taxes voluntarily. Specifically, the ability later to make the particular designation approved here significantly reduces the likelihood that a failing corporation will pay over to the government the taxes that it has withheld from its employees. Knowing that there will be the opportunity in Chapter 11 proceedings to designate payments first for trust fund taxes substantially weakens the disincentive for corporate officers to use the trust fund in a last-ditch effort to alleviate a corporation's pre-bankruptcy financial difficulties. The specter of Section 6672 liability would be removed as a deterrent to the conversion of trust funds if the responsible persons believe that they can ultimately escape liability under cover of Chapter 11 if the corporation's financial difficulties prove insurmountable.

The decision below also undermines the congressional policies favoring collection of trust fund taxes and of federal tax liabilities in general in bankruptcy proceedings. Congress viewed the conversion by employers of monies held in the trust fund as a particularly severe type of tax delinquency. Taxes that are withheld by an employer from its employee's wages are credited by the government to that employee's account as paid, whether or not the withheld funds are actually paid over to the government by the employer. Accordingly, the loss from the employer's failure to turn over those trust fund taxes is suffered directly by the Treasury. See 26 U.S.C. 31(a); *Slodov* v. *United States*, 436 U.S. 238, 243 (1978). To prevent such losses, Congress enacted Section 6672 to impose personal liability in the amount of delinquent withholding taxes directly upon the persons responsible for not turning them over to the government. This provision establishes not only an alternative means of collection but also a strong disincentive to corporate officers to draw upon withheld taxes to alleviate a corporation's financial difficulties. See *Slodov* v. *United States*, 436 U.S. at 243; *United States* v. *Sotelo*, 436 U.S. 268, 277 n.10 (1978).

The decision below, however, allows responsible persons to use the corporate Chapter 11 proceedings as a shield to protect themselves from Section 6672. The designation sought here benefits the responsible persons of the corporation (by reducing their Section 6672 liability) while providing, at most, only a speculative benefit to the corporation. At the same time, it compromises the protection afforded the public fisc by Section 6672. Corporate tax payments that would otherwise be applied to reduce the corporation's other tax liabilities for which there is no alternative means of collection will instead be applied first to reduce the potential exposure of the corporate officers for the delinquent trust fund liabilities. Thus, in the event the delinquent taxes are only partially paid under the reorganization plan, the Treasury will suffer a loss.

b. The bankruptcy court lacks authority to direct the IRS to allocate payments first to the outstanding trust fund liability. Clearly, there is no provision expressly conferring this authority, and the court of appeals erred in reading such authority into 11 U.S.C. 105, which empowers bankruptcy courts to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title." That general provision speaks to the procedural powers of the court; the legislative history explains that it is designed to extend the power of the All Writs Act (28 U.S.C. 1651) to bankruptcy courts, as well as to cover any other powers traditionally exercised by bankruptcy courts under the old Bankruptcy Act. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 316-317 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 29 (1978). Thus, the courts have recognized that the purpose of Section 105 is to allow the bankruptcy court to issue equitable orders such as injunctions and stays and to punish contempt in cases where such orders are consistent with the Bankruptcy Code; its purpose is not to give the bankruptcy court

leeway to create new substantive rights for debtors. See, *e.g.*, *Bird* v. *Carl's Grocery Co.* (*In re NWFX, Inc.*), 864 F.2d 593, 595 (8th Cir. 1989); *Official Committee of Equity Security Holders* v. *Mabey*, 832 F.2d 299, 302 (4th Cir. 1987); *United States* v. *Sutton*, 786 F.2d 1305, 1307-1308 (5th Cir. 1986).

The designation orders approved by the court of appeals here plainly fall outside the scope of this authority. The bankruptcy court does not have "a roving commission to do equity" (*United States* v. *Sutton*, 786 F.2d at 1308) or to issue any order that conceivably could aid the rehabilitation of the debtor. Rather, it is bound to implement the substantive rules established in the Bankruptcy Code and to observe other requirements of law. The designation order here does not help to "carry out the provisions" of the Bankruptcy Code (11 U.S.C. 105); indeed, it runs counter to the Code provisions that seek to secure the payment of delinquent taxes. The Bankruptcy Code establishes a priority system for the payment of outstanding debts in which the taxes owed by respondents are accorded a high priority (see 11 U.S.C. 507(a) (1982 & Supp. V 1987)); thus, it is not appropriate for the bankruptcy court to upset settled rules in order to enhance the prospects of unsecured creditors at the acknowledged expense of the IRS's ability to collect its priority taxes (see App., *infra*, 21a).

In enacting the Bankruptcy Code, Congress weighed the government's right to collect its taxes against the competing interests of the general creditors in collecting their debts and the debtor's desire to obtain a "fresh start." See *e.g.*, S. Rep. No. 989, *supra*, at 13-14. There is no suggestion, however, that Congress intended to confer upon the bankruptcy court power to designate tax payments, to the detriment of the IRS's ability to collect taxes, in order to entice responsible persons to release claims against the

debtor or to cooperate in obtaining financing. It is undoubtedly true that the success of a reorganization may be jeopardized if the debtor's officers are, for whatever reason, unwilling to cooperate fully in the reorganization. But that does not give the bankruptcy court carte blanche to enter orders designed to secure such cooperation by assisting the officers at the expense of another party to the bankruptcy. As the district court stated in *Newport Offshore* (App., *infra*, 29a-30a), Congress did not "intend that a principal stockholder of a corporation in reorganization would have the ability to negotiate in Bankruptcy Court an exculpatory provision with respect to the trust fund taxes."[7] The general principle regarding the allocation of involuntary tax payments should be fully applicable here, and a corporate debtor in Chapter 11 should not be permitted to insist on application of its payments first to trust fund taxes in order to eliminate its officers' Section 6672 liability.

3. Resolution of the question presented here is of great importance to the administration of the tax laws. The issue of the validity of a corporate designation in a Chapter 11 plan is one that frequently recurs because most corporate bankruptcies involve withholding tax liability, and the lower courts are in considerable disarray on the issue. Thus, resolution of the conflict will eliminate disparate

[7] Indeed, those responsible persons would not be able to obtain that relief in their own personal bankruptcy proceedings. Section 6672 liabilities would be entitled to priority of payment in those proceedings and, to the extent not satisfied therein, they would not be dischargeable, but would remain an enforceable debt after bankruptcy. See 11 U.S.C. 507(a)(7)(C), 523(a)(1) (1982 & Supp. V 1987). It is inappropriate for the bankruptcy court to permit the same officers to use the threat of noncooperation in the corporate debtor's reorganization to achieve personal relief that they could not obtain in their own bankruptcy proceedings.

results among taxpayers depending upon the jurisdiction in which they file their Chapter 11 petition. Moreover, the issue has significant fiscal impact upon the government. When a Chapter 11 reorganization fails after a few payments are made, as many of them do,[8] the effect of the designation is to reduce the total amount of the outstanding tax liability that may be collected by the government because of the reduction in the responsible persons' Section 6672 liability.[9] Allowing such a designation thus shifts the risk of failure of the plan from the responsible officers, whose improper conduct created the delinquency in the first place, to the government. And, as we have explained (pp. 16-17, *supra*), it would also tend to increase arrearages in trust fund payments by reducing the officers' incentive to make voluntary payments prior to bankruptcy. At all events, resolution by this Court of the conflict in the courts of appeals is required if there is to be even-handed administration of the tax and bankruptcy laws.

[8] The Administrative Office of the United States Courts has estimated that 90% of Chapter 11 reorganizations fail. See *In re Timbers of Inwood Forest Assocs., Ltd.*, 808 F.2d 363, 382 (5th Cir. 1987) (Jones, J., dissenting), aff'd, 108 S. Ct. 626 (1988). Indeed, if there were not a considerable likelihood that the plan would fail, the designation issue would be of no concern to the responsible officers since the plan must provide for the payment of all trust fund taxes by the corporate debtor within six years.

[9] The Collection Division of the IRS estimates that up to $34 million per year in tax revenue could be lost if designations are permitted routinely.

CONCLUSION

The petition for writs of certiorari should be granted.
Respectfully submitted.

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AUGUST 1989

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 87-1896

IN RE ENERGY RESOURCES CO., INC., DEBTOR

INTERNAL REVENUE SERVICE, PLAINTIFF, APPELLANT

v.

ENERGY RESOURCES, CO., INC., DEFENDANT, APPELLEE

APPEAL FROM THE UNITED DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS
[Hon. John J. McNaught, *U.S. District Judge*]

No. 88-1175

IN RE NEWPORT OFFSHORE, LTD., DEBTOR

UNITED STATES OF AMERICA, PLAINTIFF, APPELLEE

v.

NEWPORT OFFSHORE, LTD., DEFENDANT, APPELLANT

APPEAL FROM THE UNITED DISTRICT COURT
FOR THE DISTRICT OF RHODE ISLAND
[Hon. Francis J. Boyle, *U.S. District Judge*]

March 31, 1989

Before: Bownes and Breyer, *Circuit Judges*, and Caffrey,* *Senior District Judge*

BREYER, *Circuit Judge*. The Internal Revenue Code requires employers to withhold from their employees' paychecks money representing employees' personal income taxes, unemployment insurance and social security taxes that those employees owe or will owe the government. 26 U.S.C. §§ 3102(a), 3402(a) (1982). Because federal law requires employers to hold these funds in "trust for the United States," 26 U.S.C. § 7501(a) (1982), these taxes are commonly referred to as "trust fund" taxes. *Slodov* v. *United States*, 436 U.S. 238, 242-43 (1978). And, should employers fail to pay them, the government can collect an equivalent sum directly from the officers or employees of the employer who are responsible for their collection and payment. 26 U.S.C. § 6672 (1982). These individuals are commonly referred to as "responsible" individuals. *Slodov*, 436 U.S. at 244 n.5. An employer, of course, may also fail to pay the government its ordinary corporate income tax or other "non-trust fund" taxes (*i.e.*, taxes owed directly by the corporation and not withheld or collected from third parties).

These two cases involve corporations in Chapter 11 bankruptcy reorganizations. Each corporation owes the government both trust fund and ordinary (non-trust fund) taxes. In each instance, the reorganization plan says that the corporation must satisfy its total tax debt to the

* Of the District of Massachusetts, sitting by designation.

government by making partial payments each year for several years. In each instance, the bankruptcy judge specified that, as the reorganized corporation paid off its tax debts, the government should treat the payments as satisfying the corporation's *trust fund tax* debts *first*; only after it received enough money to satisfy all trust fund debts may the government apply the money received to the corporation's non-trust fund tax debts. This order of payment helps the "responsible" individuals associated with the corporation, for it diminishes the likelihood that they will end up having *personally* to pay the "trust fund" tax debts that the corporation owes. That fact also means that the government may find it harder to collect the *entire* tax debt (trust fund and non-trust fund). If, for example, the reorganized corporation were to run out of money a few years from now and "trust fund" debts were still owed, the government might collect them from "responsible" individuals. But, if all "trust fund" debts have been paid, and if the only debts are for, say, ordinary corporate income taxes, the government will be out of luck, for there are no *personal* guarantors of payment of a corporation's ordinary tax liabilities.

The IRS has appealed these two bankruptcy court decisions. It wants to apply the debtors' payments to the ordinary, non-trust fund, tax debts first. It argues that it is entitled to do so because payments pursuant to a Chapter 11 reorganization plan are "*involuntary*" payments; and under a longstanding IRS policy, backed by case-law authority, the IRS may designate the allocation of "involuntary" payments among a firm's various tax debts as the IRS sees fit. The IRS adds that to allocate Chapter 11 tax payments to "trust fund" tax debts will frustrate the congressional policy underlying Section 6672 of the Internal Revenue Code, 26 U.S.C. § 6672 (1982), which holds "responsible" individuals personally liable for a corpora-

tion's "trust fund" tax debts. In *Energy Resources*, the district court rejected these arguments and affirmed the bankruptcy court's allocation of payments to "trust fund" debts first; in *Newport Offshore* the district court accepted these arguments and reversed the bankruptcy court's order for payment of "trust fund" tax debts first.

The basic legal question that these two cases raise on appeal is whether the bankruptcy court has the legal authority to order the government to apply the tax payments made by the reorganized corporation to the corporation "trust fund" debts first. We conclude that the bankruptcy court does possess that legal power, regardless of whether the payments are characterized as "voluntary" or "involuntary." Our result is consistent with that of the Eleventh Circuit in *In re A & B Heating & Air Conditioning, Inc.*, 823 F.2d 462 (11th Cir. 1987), *vacated and remanded for consideration of mootness*, ___ U.S. ___, 108 S. Ct. 1724 (1988). Our result is not consistent with that reached by the Third Circuit, in *In re Ribs-R-Us, Inc.*, 828 F.2d 199 (3d Cir. 1987) (tax payments made pursuant to a Chapter 11 reorganization are *per se* "involuntary" and "no provision of the Bankruptcy Code allows either the debtor or the bankruptcy court to direct" the allocation of such payments). Two other circuits have followed the Third Circuit. *In re DuCharmes & Co.*, 852 F.2d 194 (6th Cir. 1988) (per curiam); *In re Technical Knockout Graphics, Inc.*, 833 F.2d 797 (9th Cir. 1987).

I. Background

The first case before us concerns a Chapter 11 debtor called Newport Offshore, Inc. Newport Offshore failed to pay the government employee social security and unemployment withholding taxes ("trust fund" taxes) in 1985; it owes the government some ordinary, non-trust fund,

taxes as well. On November 13, 1985, Newport Offshore filed a petition for reorganization under Chapter 11 of the Bankruptcy Act, 11 U.S.C. §§ 101-1330 (1982). In June 1986, the bankruptcy court appointed a trustee to run Newport Offshore's business. *See* 11 U.S.C. § 1104 (1982 & Supp. IV 1986). Subsequently, Allied Marine Associates, a Rhode Island partnership, agreed to pay all Newport Offshore's prepetition tax liability, to pay various other debts, and to invest additional money in the corporation; in return, it would receive 85 percent of the shares of the new, reorganized Newport Offshore. The reorganization plan provided that the reorganized Newport Offshore would pay its tax debts (totalling about $300,000) over a period of about six years and that the money would be applied to extinguish all "trust fund" tax debts "prior to the commencement of payment of the non-trust fund portion" of the tax debts owed. The IRS objected to the plan's tax debt payment designation provision. The bankruptcy judge, after hearing IRS's objections, approved the plan. The IRS appealed to the district court, which reversed, following the Third Circuit in *Ribs-R-Us, supra.* The debtor now appeals that decision here.

The second case involves a debtor called Energy Resources Co., Inc. In January 1983, the debtor petitioned for reorganization under Chapter 11. In September 1984 the Bankruptcy court confirmed a reorganization plan under which all of Energy Resources' assets, except those of its Environmental Division, would be placed in a special trust (called the ERCO Liquidation Trust) to pay debts owed, including about $1,000,000 in federal taxes, most of which were trust fund taxes. The ERCO Liquidation Trust was to pay the tax debt over a period of about five years. The plan also provided that reorganized Energy Resources, Inc. would, upon merging with an independent company, continue to operate under the name Enseco,

Inc. In November 1985 the trustee of ERCO Liquidation Trust sent checks to the IRS for about $280,000, which represented the scheduled payment and $78,000 in additional payments. The trustee asked the IRS to apply the money to Energy Resources' "trust fund" tax debt. The IRS refused to accept the trustee's designation. The trustee then asked the bankruptcy court to order the IRS to apply the money to the "trust fund" tax liabilities. After hearing argument, the bankruptcy court held that tax payments made pursuant to a Chapter 11 reorganization are "voluntary" payments, and it "ordered" the IRS "to apply tax payments under the Plan as designated by the Trustee." The IRS appealed this order to the District Court, which affirmed the bankruptcy court. The IRS now appeals that decision.

II. The Law

In our view, these cases require us to answer *two* legal questions. The first legal question concerns the scope of IRS policy. It is whether a payment made pursuant to a Chapter 11 reorganization plan is "voluntary" or "involuntary," as IRS rules and regulations use these terms. Our answer to that question is similar to that of the Third Circuit. We believe that the law permits the IRS to call tax payments within a Chapter 11 reorganization "involuntary," for purposes of applying its own regulations. We reach a result that differs from the Third Circuit, however, because we believe we must ask a second question: Does the law permit a bankruptcy court to order the IRS to allocate an "involuntarily" made payment to a debtor's "trust fund" tax liability first? We conclude that the law does authorize a bankruptcy court to order the IRS to allocate such "involuntary" payments to a taxpayer's "trust fund" liability first, provided that the court reasonably

concludes that this allocation will likely increase the reorganization plan's chances for success. We shall analyze each of these two legal questions in turn.

A. The "IRS Rule" Question: "Voluntary" or "Involuntary"?

IRS policy has long permitted a taxpayer who "*voluntarily*" submits a payment to the IRS to designate the tax liability (*i.e.*, "trust fund" or non-trust fund tax debts) to which the payment will apply. *See* Rev. Rul. 79-284, 1979-2 C.B. 83, *modifying* Rev. Rul. 73-305, 1973-2 C.B. 43, *superseding* Rev. Rul. 58-239, 1958-1 C.B. 94 ("partial payments of . . . tax[es] are to be applied as the taxpayer designates . . . where the taxpayer provides specific written instruction for the application of a voluntary partial payments"); *Slodov*, 436 U.S. at 252 n.15. *In re Technical Knockout Graphics, Inc.*, 833 F.2d at 801; *In re Ribs-R-Us, Inc.*, 828 F.2d at 201; *In re A & B Heating & Air Conditioning*, 823 F.2d at 436; *Muntwyler* v. *United States*, 703 F.2d 1030, 1032 (7th Cir. 1983); *O'Dell* v. *United States*, 326 F.2d 451, 456 (10th Cir. 1964); *see also Wood* v. *United States*, 808 F.2d 411, 416 (5th Cir. 1987). However, where the taxpayer "*involuntarily*" makes the payment, the IRS has granted the taxpayer no such freedom to designate the allocation; the IRS will decide to apply the payment; and it will almost always decide to apply the payments to a non-trust fund tax debt first. *See* IRS Policy Statement P-5-60, *reprinted in* 1 Administration, Internal Revenue Manual (CCH) 1305-15; *Slodov, 436 U.S. at 252 n.15; In re Technical Knockout Graphics, Inc.*, 833 F.2d at 801; *In re Ribs-R-Us, Inc.*, 828 F.2d at 201; *In re A & B Heating & Air Conditioning*, 823 F.2d at 436; *Muntwyler*, 703 F.2d at 1032.

These payment designation rules, says the IRS, are consistent with "the common law" policy,

> generally recognized between creditors and debtors, that the debtor may indicate which debt he intends to

> pay when he voluntarily submits a payment to his creditor, but may not dictate the application of funds that the creditor collects from him.

In re Energy Resources Co., Inc., Brief for Appellants [IRS], at 18 n.11. *See O'Dell* v. *United States*, 326 F.2d 451, 456 (10th Cir. 1964); *see also Hewitt* v. *United States*, 377 F.2d 921, 925 (5th Cir. 1966). The IRS adds that the Tax Court defined the "voluntary"/"involuntary" distinction authoritatively in *Amos* v. *Commissioner*, 47 T.C. 65 (1966), where it said,

> [a]n involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.

Amos, 47 T.C. at 69. *But see also Muntwyler*, 703 F.2d at 1033 ("The distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money, as in a levy." (emphasis in the original).

The IRS argues that payments made by compromise pursuant to a Chapter 11 reorganization plan fall within the (rearranged) literal words of *Amos* ("payment received as a result of a legal proceeding in which the government is seeking to file a claim for its delinquent taxes"); it sees a payment made pursuant to a Chapter 11 plan as a payment made pursuant to a court order; and it distinguishes *Muntwyler* on the ground that the trustee there did not act pursuant to a *court* order, or a bankruptcy proceeding, thus taking the case outside the scope of *Amos*'s words "legal proceeding."

In essence, the IRS sees the words "voluntary" and "involuntary" as defining polar opposite points on a spectrum. At the "voluntary" end, one finds the taxpayer who discharges a debt *before* the IRS brings a legal proceeding against him. At the "involuntary" end, one finds the taxpayer whose property the court has seized and transmitted to the IRS. The IRS believes that the court's control of the taxpayer's assets in a Chapter 11 proceeding, along with the court's power to confirm the plan, bring this case close enough to the "involuntary" end of the spectrum to warrant the finding that all payments made pursuant to a Chapter 11 reorganization plan are "involuntary."

The debtor corporations, Energy Resources Co. and Newport Offshore, Ltd., counter that *Muntwyler's* phrase "resulting in an actual *seizure*" applies to court action as well as to administrative action, and that the "limited role of the court in confirming [a reorganization] plan demonstrate[s] that the action of a Chapter 11 court falls far short of the coercive power of a levy, execution or judicial sale." *In re Energy Resources*, Brief for Appellee, at 12. Therefore, they conclude, tax payments made subject to a Chapter 11 reorganization plan are not "involuntary" tax payments.

The bankruptcy courts have split over the question of whether tax payments made pursuant to Chapter 11 reorganizations are "voluntary" or "involuntary." *See* cases collected in *In re A & B Heating & Air Conditioning*, 823 F.2d at 463 n.2. As we pointed out above, at p. 6, *supra*, the circuit courts have also divided on the question. In *re Ribs-R-Us, Inc., supra*, the Third Circuit concluded that such payments are "most realistically classified as involuntary for purposes of the debtor's ability to designate to which taxes the payments should be allocated." *Rib-R-Us*, 828 F.2d at 203. The Ninth and Sixth Circuit have followed the Third Circuit's *Ribs-R-Us* reasoning. *See In re*

Technical Knockout Graphics, Inc., supra; *In re DuCharmes & Co., supra*. The Eleventh Circuit, however, in *In re A & B Heating & Air Conditioning, supra,* held that payments made pursuant to a Chapter 11 reorganization plan, at least sometimes, are "voluntary."

In our view, the labeling question is a difficult one because a Chapter 11 proceeding has *some* characteristics that make one consider a related tax payment "involuntary," but it also has *other* characteristics that make a "voluntary" label seem more natural. The Third Circuit, in *Ribs-R-Us,* 828 F.2d at 202-03, has pointed to those features of a Chapter 11 proceeding that make the payment seem "involuntary:" (1) Once a debtor files for reorganization under Chapter 11 all its assets vest in the bankruptcy estate, 11 U.S.C. § 541 (1982 & Supp. IV 1986). (2) The debtor-in-possession (or other trustee) is no longer free to spend the debtor's money; rather, he must act as a "fiduciary" for the benefit of the creditor, 11 U.S.C. § 1107 (1982 & Supp. IV 1986); *see Wolf* v. *Weinstein*, 372 U.S. 633, 649-50 (1963), and, he must act in accordance with orders the bankruptcy court may issue, 11 U.S.C. §§ 105(a); 1141(a), 1142(b) (1982 & Supp. IV 1986). (3) The bankruptcy court will determine the effect of the debtor's tax liability, 11 U.S.C. § 505 (1982 & Supp. IV 1986). (4) The debtor *must* produce a plan that will see that all tax claims (those enjoying what is now called a "seventh priority," 11 U.S.C. § 507(a)(7) (Supp. IV 1986)) are paid in full "over a period not exceeding six years after the date of assessment of such claim[s]," 11 U.S.C. § 1129(a)(9)(C) (Supp. IV 1986). (5) A bankruptcy court order confirming a plan is an order requiring the debtor (or trustee) to carry out the plan, 11 U.S.C. § 1142 (Supp. IV 1986), including, of course, its payment schedule. (6) If the debtor fails to produce, or comply, with such a plan, the bankruptcy court may convert the proceeding, against

the debtor's wishes, into a Chapter 7 liquidation, 11 U.S.C. 1112(b) (1982 & Supp. IV 1986), which invariably will involve a bankruptcy court order requiring the debtor (or the trustee), to pay assets to the government to satisfy tax liabilities.

On the other hand, a Chapter 11 proceeding also has important features that favor application of a "voluntary" label. They include the following: (1) The debtor may choose "voluntarily" to enter a Chapter 11 reorganization proceeding (2) The Chapter 11 proceeding offers the taxpayer *protection* from creditors, *including the IRS*; the debtor need not pay its tax debts for six years, 11 U.S.C. § 1129(a)(9)(C), and, as a practical matter, given that six year leeway, it may take the IRS longer to get its money from such a taxpayer than from delinquent taxpayers who are not in bankruptcy, against whom the IRS can demand immediate payment and pursue such legal action as a obtaining a levy on the debtor's property. (3) Chapter 11 gives the debtor many "options" for structuring payment and considerable "latitude" as to "how and when the IRS will be paid." *In re Lifescape, Inc.*, 54 B.R. 526, 528 (Bankr. D.Colo. 1985). (4) Here, third parties (Allied Marines in *Newport* and Enseco in *In re Energy Resources*) provided the money (or much of the money) used to pay the IRS; no law nor any court order *required* these third parties to provide their money. Moreover, the bankruptcy judge in *Newport* wrote that this feature of these cases is not unusual. He said "in the real world of business reorganizations, most successful Chapter 11 plans depend, in part, at least, on the infusion of funds provided by outside investors." (5) If a debtor fails to produce an acceptable Chapter 11 plan, the bankruptcy court need not convert the proceeding into a Chapter 7 liquidation; the court may decide simply to dismiss the proceeding, 11 U.S.C. § 1112(b), leaving the debtor back

where he started; (6) Under historic bankruptcy practice, a debtor can propose *which* of a creditor's several debts a particular payment shall satisfy. *See National Bank of the Commonwealth* v. *Mechanics' National Bank*, 94 U.S. 437, 439 (1876) ("The rule settled by this court as to the application of payment is, that the debtor or party paying the money may, if he chooses to do so, direct its appropriation.") And, this practice is important considering the IRS suggestion that its "voluntary"/involuntary" rule basically mimics ordinary debtor/creditor law. *See* p. 11, *supra*.

Given the strength of both sets of competing considerations, we are not surprised to find a split in the circuits. We recognize, however, that when we evaluate these considerations, we must pay particular attention to an interpretation that a government agency offers of *its own rules and regulations*. *Ford Motor Credit Co.* v. *Milhollin*, 444 U.S. 555, 565-66 (1980); *Bowles* v. *Seminole Rock & Sand Co.*, 325 U.S. 410, 413-14 (1945); *LaFlower* v. *United States*, 849 F.2d 8, 12 (1st Cir. 1988); *United States* v. *Franchi-Forlando*, 838 F.2d 585, 588 (1st Cir. 1988). Despite the strength of the arguments favoring a determination that these payments are voluntary, we cannot say that the IRS's view is *clearly* unreasonable. We therefore accept its view that payments made pursuant to a Chapter 11 plan are "involuntary" for purposes of its own rules. That conclusion only means, however, that the *IRS's own rules and regulations* do not *compel* it to accept the taxpayers' determinations as to how it must apply payments here at issue. *See Arizona Grocery Co.* v. *Atchison, Topeka & Santa Fe Railway Co.*, 284 U.S. 370, 389-90 (1932) (an agency must follow its own rules).

B. The Bankruptcy Court's Power to Allocate Tax Payments

A central legal question remains: Does a bankruptcy court possess the legal power to order the IRS to apply a

payment in a way that runs *counter* to IRS's own internal policies? That is to say, may a bankruptcy court order the IRS to apply an "involuntary" payment made by a Chapter 11 debtor to "trust fund" tax liabilities first, and only later apply payments to ordinary, non-trust fund tax liabilities? *Compare In re A & B Heating & Air Conditioning*, 823 F.2d at 464 (noting tension between Internal Revenue Code's aim to "maximize the public fisc" and the Bankruptcy Code's "preference toward reorganization rather than liquidation"). We conclude that the answer to this question is "yes," for several reasons.

First, Congress has granted bankruptcy courts broad equitable powers, including those powers "expressly or by necessary implication conferred by Congress." *Johnson* v. *First National Bank of Montevideo*, 719 F.2d 270, 273 (8th Cir. 1983), *cert. denied*, 104 S. Ct. 1015 (1984); *see also Pepper* v. *Litton*, 308 U.S. 295, 304-05 ("The bankruptcy courts have exercised these equitable powers in passing on a wide variety of problems arising out of the administration of bankrupt estates."); *In re Leasing Consultants, Inc.*, 592 F.2d 103, 107 (2d Cir. 1978) (bankruptcy court sits in equity); 11 U.S.C. § 1129(b)(1) (court must ensure that reorganization plan is "fair and equitable"). And historically, bankruptcy courts have been called upon to use their powers to promote the "twofold" (and often conflicting) purpose of the Bankruptcy Code: ensure fair payment to creditors *and* provide the bankrupt firm with an opportunity to make a "fresh start." *Burlington* v. *Crouse*, 228 U.S. 459 (1913). The bankruptcy court may "issue any order, process, or judgment that is necessary *or appropriate* to carry out the provisions" of the Bankruptcy Code. 11 U.S.C. § 105 (emphasis added). At least on some occasions, an order allocating Chapter 11 tax payments to "trust fund" liabilities first would seem "appropriate." Suppose, for example, that certain third parties that included "responsible" individuals were willing to advance

enough money to rehabilitate the corporation only if the court would assure them that the reorganized corporation would pay its "trust fund" tax debts first. That assurance would diminish the likelihood that the third parties would have to pay the debts personally; without it they might prefer immediate liquidation, which could mean total payment of all tax debt, and "a guarantee[] that no tax penalty will be assessed against them personally." Note, *Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS*, 70 Minn. L. Rev. 1279, 1299-1300 (1986). Of course, to give the "responsible" persons this assurance, and then allow the reorganized corporation to stretch out its tax payments over six years, might diminish the chances that the reorganizing firm will pay its *entire* tax debt, for no one can be absolutely certain that the reorganized corporation will still have money four or five years into the future. But, by giving this assurance, and thereby keeping the firm alive, the bankruptcy court would also increase the chances that the debtor will pay something to its general unsecured creditors. As the Eleventh Circuit pointed out, "[f]requently, the efforts put forth by these officers during the reorganization is the corporation's only hope for future viability." *In re Heating & Air Conditioning*, 823 F.2d at 465.

Second, bankruptcy courts have long had the legal power to tell creditors against which of a debtor's several debts they are to apply a particular payment; *see National Bank of the Commonwealth*, 94 U.S. at 439; *see also* 60 Am. Jur. 2d [*Payment*] § 103 (1987) ("A court applies involuntary payments according to principles of equity and justice, according to intrinsic justice or the equity of the case, according to rights and priorities concerned, or ratably to all debts, and in such a way as will best maintain and protect the rights of all the parties.") (citations omitted). There is case law authority holding that courts may order the IRS to ignore its own "allocation" rules. *See*

Commercial Credit Corporation v. *Schwartz*, 130 F. Supp. 524, 530-31 (E.D. Ark. 1955) (federal district court exercised its equitable powers to set aside IRS allocation of involuntary payment because allocation was unfair to other creditors); *cf. Amos* v. *Commissioner*, 47 T.C. 65, 70 n.5 (1966) ("We expressly refrain from deciding whether the same right of application governs where the rights of other creditors may be adversely affected."). And, to the extent that courts have held to the contrary, they have simply assumed that the IRS's internal "voluntary"/"involuntary" categorization determined the matter without considering whether a bankruptcy court held the legal power to allocate tax payments over the IRS's objection. See cases cited at p. 11, *supra*.

Third, nothing in the bankruptcy statute limits, in any relevant way, the bankruptcy court's power to allocate when the creditor is the IRS. To the contrary, Congress specifically granted the bankruptcy court the power to restucture tax debts, along with other debts, insisting, only by way of compromise, that a Chapter 11 plan must ensure that the debtor will pay all tax debts *within six years* (from the date of assessment.) We must read the absence of such restrictions in light of Congress' specific regulation of the compromise nature of Chapter 11's tax debt policy. The Senate wrote:

> In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding.
>
> . . .
>
> A three-way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumu-

> lation of taxes for past years; (2) the debtor, whose "fresh start" should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law has restrained him from collecting.

S. Rep. No. 989, 95th Cong., 2d Sess. 13-14, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5799-800. We cannot assume that Congress automatically preferred the resolution of all such tension (illustrated by the issue before us) in favor of the IRS.

Fourth, it makes administrative sense for the bankruptcy court to have the power to determine, in some cases, the debt allocation of Chapter 11 tax payments. It is unlikely that the IRS, charged with the duty to collect taxes rather than to worry about firms in bankruptcy, could easily balance on a case-by-case basis the increased "tax collection" risk against the increased likelihood of "rehabilitation." But, it is very likely that the bankruptcy court could and would do so; indeed, it is just this kind of work that it ordinarily performs. Of course, the statute requires the bankruptcy court to assure itself that reoganization will succeed, 11 U.S.C. § 1129(a)(11) (1982), and that therefore, the IRS, in all likelihood, will collect the *total* tax debt owed; and that court has no more than a six year leeway within which to structure payments. 11 U.S.C. § 1129(a)(9)(C). But, acting *within* that leeway, it would seem to make administrative sense to permit the court to structure not only times and amounts of payment, but also the particular tax debt to which each payment shall be allocated.

Fifth, the IRS's policy of allocating payments first to a corporate debtor's non-trust fund tax liability is not a statutory policy. That policy, created by internal rule, is designed to preserve the liability of the "responsible" individuals. It thereby increases the likelihood that the IRS will ultimately collect the *entire* tax debt ("trust fund" and non-trust fund) owed by the corporation. This objection is understandable, even commendable, for an agency whose mission is to *collect taxes*. *See* Rev. Rul. 79-284, 1979-2 C.B. 83, *modifying* Rev. Rul. 73-305, 1973-2 C.B. 43, *superseding* Rev. Rul. 58-239, 1958-1 C.B. 94 ("[T]he Internal Revenue Service will allocate partial payments of withheld employment taxes . . . *in a manner serving [the IRS'] best interests.*") (emphasis added). But, we can find no *statute* that attaches so overriding an importance to this tax objective as to circumscribe a court's statutorily granted powers to the contrary. As a general matter, the IRS cannot, in any obvious way, circumscribe, by using an internal rule, a court's statutory powers. *See Dixon* v. *United States*, 381 U.S. 68, 74 (1965).

Sixth, we can find no policy embodied in any specific statute, tax or otherwise, that either directly, or by manifesting a congressional intent, circumscribes a bankruptcy court's general powers in the respect at issue here. The IRS argues strongly that requiring the IRS to allocate tax payments in Chapter 11 proceedings to "trust fund" debts first would frustrate the congressional intent of 11 U.S.C. § 6672—the statute that permits the IRS to collect unpaid "trust fund" taxes directly from the personal assets of "responsible" individuals. But, we do not see how that is so.

We agree with the IRS that Section 6672 reflects a strong congressional policy to collect "trust fund" tax liabilities. Such a policy reflects the fact that if a corporation is unable to pay its "trust fund" taxes, the United States Treasury suffers the loss because the employees from whose wages the taxes are withheld are still credited with those amounts as if they had in fact been paid to the government. *United States* v. *Huckabee Auto Co.*, 783

F.2d 1546, 1548 (11th Cir. 1986); *In re Avildsen Tools & Machine, Inc.*, 794 F.2d 1248, 1251 n.6 (7th Cir. 1986). But, we do not agree that such a policy helps the IRS in its argument. Indeed, the IRS's argument seems to stand the policy of Section 6672 on its head: The IRS's Chapter 11 allocation policy and interpretation of Section 6672 does not assure that "trust fund" taxes are promptly turned over to the government. Rather, it ensures that "trust fund" money is paid over *last*, only after all non-trust fund taxes have been paid.

The IRS seeks to use the personal liability of "responsible" persons, not to help collect "trust fund" tax debts, but to collect *total* tax debts. And, in order to help maximize that total collection, it is willing, by not crediting the "trust fund" debt first, to run a greater risk of *not* collecting the 'trust fund" debt at all, as would be the case if the reorganized corporation ran out of money while paying the non-trust fund tax debt and there were no personal assets of "responsible" persons. In this way, the IRS's allocation policy gives ordinary, *non*-trust fund tax debts a special status; it places the payment of "trust fund" tax debts at risk; and it effectively forces the "responsible" persons to be liable for the *last* tax dollars due from the debtor, a liability which Congress did not say "responsible" persons ought to have. Section 6672 does refer to "responsible" person liability as a "penalty" but this characterization "does not alter their essential character as taxes." *United States* v. *Sotelo*, 436 U.S. 268, 275 (1978); *Huckabee Auto Co.*, 783 F.2d at 1548 ("Although denoted a penalty in the statute, the liability imposed by section 6672 is not penal in nature, but is 'simply a means of ensuring that the tax is paid.' ") (quoting *Botta* v. *Scanlon*, 314 F.2d 392, 393 (2d Cir. 1963)) (citation omitted). And, the IRS collects the amount of the unpaid trust fund taxes *only once*, from the

"responsible" individuals, the corporate debtor, or some combination thereof. *Sotelo*, 436 U.S. at 279 n.12; *USLIFE Title Ins. Co.* v. *Harbison*, 784 F.2d 1238, 1243 & n.7 (5th Cir. 1986) (citing IRS Policy Statement P-5-60, *supra*). Indeed, the IRS itself has said that it would try to collect trust fund taxes from responsible individuals " 'only when all other means of securing the delinquent taxes have been exhausted.' " *Sotelo*, 436 U.S. at 279-280 (quoting Opinion B-137762 (May 3, 1977), *reprinted in* CCH 1977 Stand. Fed. Tax Rep. ¶ 6614, at 71,438 (statement of Comptroller General of United States)).

A simple example will help illustrate our problem with the IRS argument. Assume, for example, that a debtor owes the IRS $1 million in "trust fund" tax liabilities and $5 million in ordinary, non-trust fund tax liabilities. Assume further that the Chapter 11 reorganization plan schedules payments of $1 million per year for six years. Although the bankruptcy court will not approve such a schedule unless it is convinced that the debtor will pay the entire $6 million over the six years, we can understand the IRS's fear that risk of noncollection for later payments is greater than for earlier payments. We cannot, however, understand the IRS's argument that a bankruptcy court's insistence that the IRS apply the first $1 million payment to "*trust fund*" debts inhibits its collection of such debts. Such an allocation does indeed tend to prevent the IRS from pursuing "responsible" individuals for the money after Year One (or if the IRS has pursued them, they can obtain a refund, 26 U.S.C. § 6511(a) (1982)); but that is only because the *"trust fund" debts have been paid.* If the IRS were anxious simply to check off the tax liabilities in its "trust fund" books, it would as we have said, try to get this money in Year One, not Year Six (by which time the risk increases that both debtor corporation and "responsible" individuals will lack the assets to pay.)

In fact, because money is fungible, the effect of the bankruptcy court's ruling is to diminish the IRS's ability (by looking to "guarantors" of the "trust fund" $1 million) to obtain the *whole* six million. But, that ruling releases the guarantor only to the extent that the IRS *actually receives* $1 million, the full "trust fund" liability; and as to the remaining $5 million, the IRS is no worse off than had the *entire debt* been an ordinary tax debt without a "trust fund" component. And, so long as there is a "trust fund" tax debt outstanding, nothing, including our opinion today, legally restrains the IRS from attempting to collect "trust fund" taxes from "responsible" individuals. *See In re LaSalle Rolling Mills*, 832 F.2d 390 (7th Cir. 1987) (Anti-injunction Act prohibits courts from restraining IRS from collecting "trust fund" taxes from individuals under § 6672); *A to Z Welding & Manufacturing, Co.* v. *United States*, 803 F.2d 932 (8th Cir. 1984) (same); *Huckabee Auto Co., supra.*

As we have said, we can find no policy in any statute suggesting that Congress felt that bankruptcy courts must maximize the likelihood that the IRS will receive its entire tax debt, irrespective of all other goals, particularly the Bankruptcy Code's preference for rehabilitation over liquidation. We note that a bill introduced in the House of Representatives would give the IRS the very statutory power it seeks here. *See* H. R. 3984, 100th Cong., 2d Sess. § 201 (1988) (proposing that Section 505 of title 11 of the United States Code be amended to include that "[p]ayments of taxes under this title to a governmental unit may be applied by the governmental unit in a manner that preserves alternative sources of collection, if any"). But, Congress has not enacted that bill into law.

Thus, in weighing the competing aims of the Bankruptcy Code and Internal Revenue Code, we reach the same result as the Eleventh Circuit in *In re A & B Heating*

& Air Conditioning, supra. We hold that " 'the allocation question in a Chapter 11 case under the Bankruptcy Code should be left to judicial discretion to be decided on a case-by-case basis.' " *Id.* at 465 (quoting *In re B & P Enterprises, Inc.*, 67 B.R. 179, 183 (Bankr. W.D.Tenn. 1986)). Specifically, the bankruptcy court should make the following inquiry: upon consideration of the reorganization plan as a whole, in so far as the particular structure or allocation of payments increases the risk that the IRS may not collect the total tax debt, is that risk nonetheless justified by an offsetting increased likelihood of rehabilitation, *i.e.*, increased likelihood of payment to creditors who might otherwise lose their money? And, the standard for judging the lawfulness of any such bankruptcy court action should be similar to that applied to other bankruptcy court tax-related actions. *See e.g., Darman* v. *Metropolitan Alarm Corp.*, 528 F.2d 908 (1st Cir. 1976) (findings of fact by bankruptcy judge entitled to stand unless "clearly erroneous"). In applying this test, of course, the bankruptcy court must recognize the obvious importance of satisfying tax liabilities, but where this test is satisfied, we are convinced that the bankruptcy court has the legal power to order the allocation.

IV. The Result

We have also considered whether or not we we must remand these cases to the bankruptcy court for reconsideration in light of the appropriate standard. We should do so if these courts ordered the "trust fund" debt paid first *simply because* they thought the IRS rules so required, *i.e.*, if they did so simply because they thought these payments were "voluntary," and if they might have exercised their legal authority differently had they realized that their allocation orders ran contrary to IRS policy. Having

examined the opinions of the bankruptcy courts and the records in these cases, we conclude that no remand is necessary.

The bankruptcy judges in both cases clearly understood the IRS's opposition to their "trust fund" allocation orders. The bankruptcy judge in *Newport Offshore* considered that he had the legal "flexibility" to allocate payments to "trust fund" tax debt when bankruptcy related circumstances so required. He wrote that he considered the "totality of the circumstances," he noted the special circumstances that a "third party, Allied Marine Associates," provided funding for the plan, and he rejected as without "factual or practical support" the IRS claim that the allocation would do no more than benefit a particular individual who was a "responsible" person. Moreover, given the presence of the third party, the record offers adequate support for the reasonableness of a determination that the allocation order is both fair and will help to rehabilitate the company. Under these circumstances, we do not believe that remanding could serve any purpose.

The bankruptcy court opinion in *In re Energy Resources* indicates less clearly that the court would reach the same conclusion had it been aware of our eventual conclusion about the law. The court seemed to base its result upon its "voluntary" versus "involuntary" analysis. Nonetheless, that court held a special hearing about whether it should order the IRS to accept the taxpayer's payment designation, it heard argument about the trustee's claim that the designation would not significantly hurt the IRS, and that it was "necessary" for the trustee to maximize the extent to which the IRS payments would "benefit the estate." In addition, the bankruptcy judge found that "the Plan in the instant case and the tax payments at issue were made possible, at least in part, by the infusion of capital" from a third party. And, in issuing the order it specifically rested

its decision upon the "entire record of the case and the arguments of counsel." The record makes us reasonably certain that the court would not have reached a different result had it been fully aware that it was ordering the IRS to accept a designation contrary to IRS rules. And, the record provides adequate support for the court's conclusion.

For these reasons, we conclude that the orders of the bankruptcy judges in both cases are lawful. Therefore, the judgment of the district court in *In re Newport Offshore Ltd.* is

Reversed.

The judgment of the district court in *In re Energy Resources Co.* is

Affirmed.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

Civil Action No. 86-1533Mc

IN RE ENERGY RESOURCES CO., INC., DEBTOR

UNITED STATES OF AMERICA, APPELLANT

v.

ENERGY RESOURCES, CO., INC., APPELLEE

August 5, 1987

Memorandum and Order

MC NAUGHT, D.J.

The issue presented by this appeal was whether the bankruptcy court erred in holding that the payments of tax pursuant to a Chapter 11 Plan were voluntary, and therefore, their application could be directed by the Trustee. *Muntwyler v. United States*, 703 F.2d 1030, 1032 (7th Cir., 1983). If payments are "involuntary", the Trustee may not direct the application of the payments.

On April 7, 1986 the Bankruptcy Court entered an Order allowing the motion of the Liquidation Trustee, and ordering the Internal Revenue Service to apply tax payments under a confirmed Plan, as designated by the Trustee. The terms of the Plan approved by the Bankruptcy Court provide that the taxing authorities are to be paid in full with interest in four equal payments commencing one year after the confirmation date of the Plan. During the year 1985, the Trustee tendered one check in the

amount of $203,516.54, and another in the amount of $78,000, the Trustee designating to the IRS that these payments be applied first to the trust fund portions of taxes due from the debtor. The IRS refused to accept the checks under the terms of the designation, without a court order. The Bankruptcy Judge, as recited hereinbefore, granted a motion for such an order, and this appeal followed.

The basic principle, as enunciated in *Muntwyler*, supra, is that if a taxpayer's payment is "voluntary", the taxpayer may designate its allocation among tax, penalty and interest. If it is "involuntary", the taxpayer, here the Trustee, may not designate. Bankruptcy Judge James Gabriel held that the payments were voluntary, by reason of broad discretion given to debtors under § 1129 of the Bankruptcy Code. 11 U.S.C. § 1129(a)(9)(C). I agree with the conclusion of the Bankruptcy Judge that Section 1129 payments are voluntary, and that this ruling is consistent with the policies underlying Chapter 11.

The United States contends on this appeal that, since "court action" is involved in a Chapter 11 proceeding, Section 1129 payments are therefore "involuntary".

The argument of the Trustee (to the effect that the payments are voluntary) is perhaps best summed up in *In re Lifescape, Inc.*, 54 B.R. 526 (Bankr. D. Colo. 1985) in the following language: "The mere filing of a claim in a Chapter 11 proceeding is clearly not the type of court action envisioned in *Amos* and *Muntwyler* since it does not approach the 'actual seizure of money or property as in a levy'. . . . The fact that payments are made pursuant to a plan which must comply with the requirements of the Bankruptcy Code does not rise to a level of court action equivalent to a levy, judicial order, execution or judicial sale."

The reason behind the statement of the principle is the recognition by courts that Section 1129 allows "far greater flexibility" than was available under the Bankruptcy Act.

Along with the Trustee and the Judge in Bankruptcy, I see a distinction between the court's role in confirming a plan under Section 1129 and other court action, rising to the level of a seizure. It seems to me that the position of the appellant fails to recognize that the action of the Bankruptcy Court in this voluntary Chapter 11 reorganization is limited action: the approval of a plan designed by the debtor within the flexible parameters of Section 1129. The court here didn't compel action; rather, it approved a payment which a debtor wished to make.

Judge Gabriel's reliance upon decisions such as *In re A&B Heating and Air Conditioning Inc.*, 53 B.R. 54 (Bankr.M.D. Fla 1985), aff'd May 7, 1986) and *In re Lifescape, Inc.*, 54 B.R.526 (Bankr. D. Colo. 1985) is well placed.

The Order of the Bankruptcy Court is affirmed. The Internal Revenue Service is directed to apply the tax payments in accordance with the designation of the taxpayer.

/s/ JOHN MC NAUGHT
John J. Naught
United States District Judge

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF RHODE ISLAND

Docket Number CA 87-0433

UNITED STATES OF AMERICA

vs.

NEWPORT OFFSHORE, LTD.

Providence, Rhode Island
December 9, 1987

TRANSCRIPT OF PROCEEDINGS IN ABOVE-CAPTIONED CASE BEFORE CHIEF JUDGE FRANCIS J. BOYLE.

[35] THE COURT: This is an appeal from the confirmation of a plan by the Bankruptcy Judge in this district in the matter of in re Newport Offshore LCD debtor Bankruptcy Number 885723. The Bankruptcy Judge's opinion appears at 75 Bankruptcy Reporter 919 and was filed on July 14 of 1987. The plan in part provides how the tax payments, federal tax payments, should be [36] applied. Specifically the plan provides that payments be credited first to the trust fund portion of the oldest taxes. Second, to the interest on such trust fund portion of such taxes, and, third, to the oldest nontrust fund portion of the remaining tax obligations and the interests thereon.

The Interest Revenue Service objects to the application of the tax payments as proposed and argues that it be permitted to apply the tax payments first to the nontrust fund taxes in accordance with IRS policy. The significance of this is that under the provisions of 26 United States Code Section 6672 any person required to collect, truthfully

account for and pay over any tax imposed by the title is subject to personal liability if the taxes are not paid giving Internal Revenue Service something similar to two strings to its bow. That is, it may collect the taxes from the corporation or it may collect the taxes from the person involved in the corporation who has the ability to direct the payment and application of the corporation's income and assets.

The fact of the matter is that with respect to [trust] fund taxes, particularly withholding taxes and social security taxes which are withheld by the employer and not paid over to the government, the government is [37] required to credit the employee with the payment of those taxes in spite of the fact that the government does not receive those taxes. The theory of Section 6672 is that the assets of the corporation have been misapplied by the persons who had control over them in terms of not carrying out the trust which is imposed with respect to those type of taxes.

There is a thorough and complete split in the Circuits with respect to whether or not under these circumstances of this plan payments to the Internal Revenue Service are voluntary or involuntary. That split is dependent on the application of a definition of what is voluntary and what is not voluntary contained, which is contained in the Amos case. Amos versus The Commissioner, a Tax Court decision in 1966 which says that an involuntary payment of federal taxes means any payment received by agents of the United States as the result of the restraint or levy or from a legal proceeding in which the government is seeking to collect its delinquent taxes or file a claim therefor. Amos was obviously not a bankruptcy case, it's a case cited in the Tax Court. And the definition perfectly serves the purposes for which it was given. It has, however, been applied by I think the Eleventh Circuit as being the only definition, and in this instance by the Bankruptcy [38] Judge as being the

only definition of what is involuntary. The definition does not take into consideration the nature of the bankruptcy proceeding, whether a voluntary petition or not. The Bankruptcy Court takes control of the debtor's assets and which thereafter administers those assets for the benefit of all of the creditors, including Internal Revenue Service. That Internal Revenue Service is not in the position at that point in time to engage in any kind of restraint or levy or bring a legal proceeding, except file a claim in the bankruptcy proceeding and to seek relief in the Bankruptcy Court. So that it seems to me adopting the definition of Amos is to create a strawman argument here that under which the government, the Internal Revenue Service cannot possibly succeed, that by defining "involuntary" in the way that it is done it excludes bankruptcy proceedings. I don't think that's what Internal Revenue Service's policy means or how it intends to apply it. Nor do I think the Congress had that result in mind.

I'm satisfied that the better reasoning, the more complete reasoning, the more sensible reasoning is that found in the Third Circuit's more recent opinion in the matter of Ribs Are Us Incorporated in which the United States was an appellant, an opinion filed by [39] a panel of the Third Circuit on September 9, 1987, subsequent to the Bankruptcy Judge's opinion. That opinion I would incorporate in full in mine. It seems to me that it adequately argues the various points of view that have arisen with respect to this question and I believe comes down on the better side of the argument that the Congress would see to it that both of these policies work together, the policy of reorganization and the policy of collecting taxes and avoiding what is not just a loss of taxes but a double-whammy to the government in terms of these trust fund taxes, that Congress, if asked the question, would say "we did not ever intend that a principal stockholder of a cor-

poration in reorganization would have the ability to negotiate in the Bankruptcy Court an exculpatory provision with respect to the trust fund taxes, that both of these policies can coexist and should be applied coextensively." Under these circumstances, therefore, I'm going to sustain the appeal from the Bankruptcy Court and remand the matter to the Bankruptcy Court to delete the allocation provisions in the reorganization plan and for such other proceedings as may be required. The trustee may have an exception. I'm going to ask the government to prepare a form of order.

(Proceedings concluded)

APPENDIX D

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MASSACHUSETTS

Chapter 11
Nos. 83-00060-JG
83-00128-JG
83-00129-JG
83-00130-JG
83-00131-JG

IN RE:

ENERGY RESOURCES, CO., INC.,
ENERGY OPERATORS, INC.,
OILFIELD INNOVATIONS, INC.,
OILFIELD RESOURCES CO., INC. (TEXAS),
OILFIELD RESOURCES CO., INC. (DELAWARE)
DEBTORS

MEMORANDUM

This matter is before the Court on the motion of William A. Browner, Liquidation Trustee (the "Trustee") of the Erco Liquidation Trust (the "Trust") established under the Debtor's Third Amended Plan of Reorganization (the "Plan"). The Trustee seeks an order directing the Internal Revenue Service ("IRS") to apply payments under the Plan as designated by him. The IRS opposes the Trustee's motion. Both parties have briefed their respective positions. The factors are undisputed.

FACTS

On January 17, 1983 and January 31, 1983, the debtors, Energy Resources Co., Inc. and its affiliates, commenced proceedings under Chapter 11 of the Bankruptcy Code. By order dated September 5, 1984, this Court confirmed the debtors' Plan pursuant to which the Trust was established. The purpose of the Trust, as the IRS notes in its brief, is to liquidate all remaining assets of the debtors for the benefit of their creditors.

Pursuant to Article 5 of the Plan, claims of taxing authorities, including the IRS, are to be paid in full either upon such terms as the debtors and the taxing authorities may agree or in accordance with section 1129(a)(9)(C) of the Code in four equal annual payments commencing one year after the Confirmation Date (as defined in the Plan and ultimately determined to be October 1, 1984).[1] The annual payments include a repayment of principal together with interest at the statutory rate established by the Secretary of the Treasury pursuant to 26 U.S.C. § 6621. In addition to the annual payments, the Plan provides that the Trustee has the right to prepay tax claims at anytime.

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[1] The Court's order of September 5, 1984 indicates that:

> By agreement of the Debtors, Article 5 of the Plan shall be deemed modified to provide that all Finally Allowed tax claims covered thereby shall be paid over a period of four years from the Confirmation Date, as defined in the Plan, and not from the Consummation Date, and that, in any event, the Debtors and thereafter the Trustees, as defined in the Plan, shall use their best effort consistent with the payment of priority claims and administrative expenses and consistent with their duties, including their expenses under the Erco Liquidation Trust Agreement, to prepay all Finally Allowed tax claims, in whole or in part, prior to the four anniversary dates described in Article 5 of the Plan.

On November 6, 1985, the Trustee made payments to the IRS in accordance with the Plan in the amounts of $203,516.54, representing the Plan payment then due, and $78,000, representing a partial prepayment of the outstanding claim. In so doing, the Trustee designated "that this payment be applied to the trust fund portion of taxes, first for the period ended June 30, 1982 with the excess, if any, applied to the trust fund portion of the taxes for the period ended September 30, 1982."[2]

The IRS refused to acknowledge the Trustee's designation of the payment. In a letter dated November 7, 1985, its Bankruptcy Advisor advised the Trustee that "[u]nless such direction of payment is given in a court order, the United States reserves the right to apply such payment which is a distribution of a bankruptcy proceeding to its maximum benefit." As a result of the refusal of the IRS to honor his designation, the Trustee moved for an order directing the IRS to apply Plan payments as designated by the Trustee. In his motion, the Trustee argued *inter alia*:

> 1) that the ability of the Trustee to direct payments is necessary for the Trustee to maximize the benefit to the estate from such payments;
>
> 2) that the IRS will not be harmed by the designation, since the Plan provides for the payment in full of the IRS' claim, plus interest;

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[2] The court in *Muntwyler v. United States*, 703 F.2d 1030 (7th Cir. 1983) described trust fund taxes as follows:

> The Internal Revenue Code directs employers to deduct and withhold a tax upon wages paid. 26 U.S.C. § 3401(a). The withheld taxes are deemed to be held in a special fund in trust for the United States, *id.* §7501(a), and accordingly every person required to collect and pay over such a tax (including an officer of the corporation . . . , *id.* § 6671(b)) is personally liable for the full amount of the tax not paid, *id.* § 6672.

Id. at 1032.

3) that by directing payments, the Trustee is able to implement a settlement agreement with Richard Rosen, a former officer, whereby $14,000 was immediately released to the Trust and the Trustee agreed to cooperate in designating tax payments which would forestall personal liability assessed by the IRS against the former officers from affecting them and their ability to cooperate with the Trustee; and

4) that payments made under a plan of reorganization pursuant to 11 U.S.C. § 1129(a)(9)(C) are voluntary and, therefore, entitled to be designated.

In its response to the Trustee's motion, the IRS focused on the Trustee's final argument, asserting that payments made to the United States pursuant to a Chapter 11 plan are "involuntary" and the manner of their application is in the sole discretion of the United States. The question then presented for the Court is whether, in fact, tax payments made pursuant to a confirmed Chapter 11 plan of reorganization are voluntary or involuntary.

DISCUSSION

The starting point for any discussion is the general rule that a taxpayer who makes a "voluntary" tax payment to the IRS may designate, at the time of payment, the manner of allocation of such payment among tax, penalty and interest, *Muntwyler v. United States*, 703 F.2d 1030 (7th Cir. 1983); *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964), whereas a taxpayer who makes an "involuntary" payment may not designate the manner of its allocation, the IRS being free to apply such payment to maximize the amount of assessed tax that may be collected, *United States v. DeBeradinis*, 395 F.Supp. 944 (D. Conn. 1975), *aff'd*, 538 F.2nd 315 (2d Cir. 1976); *United States v. Augspurger*, 508 F.Supp. 327 (W.D.N.Y. 1981).

Courts have adopted the United States Tax Court's definition of an involuntary payment set forth in *Amos v. Commissioner*, 47 T.C. 65 (1966). It provides:

> An involuntary payment of federal taxes means any payment received by agents of the United States as a result of a distraint or levy from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.

Id. at 69. For example, the United States Court of Appeals for the Seventh Circuit stated:

> The distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money as in a levy. No authorities support the proposition that a payment is involuntary whenever an agency takes even the slightest action to collect taxes, such as filing a claim or, as appears to be a logical extention of the Government's position, telephoning or writing the taxpayer to inform him of taxes due.

Muntwyler, 703 F.2d at 1033.[3]

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[3] In *Muntwyler*, a corporation which was delinquent in paying its federal withholding taxes entered into a common law assignment to a trustee for the benefit of creditors. The IRS filed a claim with the trustee. When the trustee sent monies to the IRS, instructing that payments be applied to the trust fund portion of the corporate tax liability so that the 100% penalty assessment against the responsible officer would be partially satisfied, the IRS refused to follow his instructions. The responsible officer then filed suit seeking a refund from the IRS. The district court ruled that trustee's payment to the IRS was voluntary.

Although courts are in agreement as to the definition of "involuntary" payment, partly because of dictum in *Muntwyer*,[4] they diverge from there, leading to conflicting precedent as to whether payments to the IRS pursuant to a bankruptcy proceeding are involuntary. *Cf. In re Lifescape, Inc.*, 54 B.R. 526, 527 (Bankr. D. Colo. 1985). However, recent decisions are in agreement that the mere filing of a claim in a Chapter 11 proceeding and the confirmation of a plan of reorganization do not constitute sufficient judicial action to render payment made pursuant to a Chapter 11 plan involuntary. *In re Lifescape, Inc.*, 54 B.R. 526 (Bankr. D. Colo. 1985); *In re A&B Heating & Air Conditioning, Inc.*, 53 B.R. 54 (Bankr. M.D. Fla. 1985); *In re Franklin Press, Inc.*, 52 B.R. 151 (Bankr. D. Fla. 1985); *accord In re Hartley Plumbing Company, Inc.*, 32 B.R. 8 (Bankr. M.D. Ala. 1983); *cf. Hineline v. Household Finance Corp.*, No. 85-0100 (Bankr. N.D. Ohio Jan. 27, 1986).

The courts in the *In re Lifescape, Inc.* and *In re A&B Heating & Air Conditioning, Inc.* cases, both of which involved Chapter 11 debtors seeking to allocate payments to the IRS so that the trust fund portion of the IRS' claim would be credited first until paid in full, stressed the options a debtor has under section 1129 of the Code and the nature of the court's involvement. In a rationale specifi-

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[4] For example, the court in footnote two indicated:

> The Government might have been correct in its claim if the corporation had been in bankruptcy, which it was not. An assignment for the benefit of creditors is an act of bankruptcy and presumably any creditor, including the Government, could have proceeded to file an involuntary petition for bankruptcy based thereon. . . . We do not equate the assignment for the benefit of creditors with a formal bankruptcy proceeding.

703 F.2d at 1034 n. 2.

cally adopted by the court in *In re Lifescape, Inc.*, the court in *In re A&B Heating & Air Conditioning Co., Inc.* stated:

> Court involvement in the context of a Chapter 11 reorganization case is not the type which results in seizure of property or money as in a levy. Unlike a taxpayer faced with a government instituted collection proceeding which may lead ultimately to levy upon the taxpayer's assets, a Chapter 11 debtor enjoys great latitude in how and if a plan is proposed and thus how and when the IRS will be paid. § 1129 requires only that a plan provide for payment of prepetition taxes over a period not to exceed 6 years from the date of assessment in order that it may be confirmed. The debtor propounding a plan has a number of options with respect to treatment of a claim by the IRS and *it is the freedom afforded by these options which dictates the conclusion that payments to the IRS pursuant to a confirmed Chapter 11 plan of reorganization are voluntary.*

53 B.R. at 57 (emphasis supplied).

Likewise, the court in *In re Franklin Press, Inc.* found that payment made pursuant to a Chapter 11 plan was voluntary. In that case, the reorganization was funded by the infusion of outside capital provided or guaranteed by a third party. The court held that this established voluntariness since the third party was not subject to the court's control, in contrast to a debtor in liquidation without real options. Significantly, the Plan in the instant case and the tax payments at issue were made possible, at least in part, by the infusion of capital from Enseco, Inc.[5]

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[5] *See* Stipulation Regarding Management, Plan Funding and Asset Purchase filed March 26, 1984, Modification of Stipulation Regarding Management, Plan Funding and Asset Purchase filed April 13, 1984,

Since the facts of the cases just discussed are similar to the ones in the instant case, the Court finds their reasoning persuasive. Furthermore, the three cases primarily relied upon by the IRS are distinguishable from the instant case and the cases just discussed. For example, *In re Frost*, 47 B.R. 961 (D. Kan. 1985), unlike the instant case, did not involve section 1129. In that case, the district court, citing *Muntwyler*, reversed the bankruptcy court, which had held that payments made under a Chapter 13 plan are voluntary, because the IRS had filed a claim and because the plan had to comply with the Bankruptcy Code. The district court's reliance on the proposition that *Muntwyler* makes it clear that it is the involvement of the court and not the type of bankruptcy which makes payments by a debtor involuntary is open to serious question, *see In re Lifescape Inc.*, 54 B.R. at 529. Therefore, this Court will not follow its lead, particularly in view of the fact that section 1129 was not involved.

Likewise, in *In re Avildsen Tools and Machines, Inc.*, 40 B.R. 253 (D.C.N.D. Ill. 1984), section 1129 was not involved. In that case, both judicial orders and a judicial sale concerned the district court. Furthermore, the bankruptcy court's orders, approving and confirming the sale of the debtor's assets and authorizing the debtor to pay its liabilities from the proceeds, were issued pursuant to the Bankruptcy Act which required more court involvement in case administration than under the Code.

Finally, *In re Mister Marvins, Inc.*, 48 B.R. 279 (E.D. Mich. 1984), is distinguishable because it involved a liquidation of the debtor's assets pursuant to a court order which authorized the settlement of a claim. As the court in

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this Court's Order, dated April 13, 1984, Approving and Allowing Debtor's Motion for Approval of Stipulation with Ensco, Inc., and the Debtor's Third Amended Plan of Reorganization.

In re A&B Heating & Air Conditioning, Inc. observed, "the [c]ourt in the *Mister Marvins* case was clearly more active than is a court whose only concern is to determine if the proposed plan of reorganization meets the standards set forth in § 1129." 53 B.R. at 56.

The Court, therefore, concludes that the Trustee's payment to the IRS, pursuant to Article 5 of the debtors' confirmed Plan, as modified by the Court's order of September 5, 1984, was voluntary and that the Trustee had every right to direct the IRS to allocate the payments to the trust fund portion of taxes owed. The Court is persuaded not only by the recent cases unequivocally holding that payments made pursuant to section 1129 are voluntary but by common sense as well.

Historically, bankruptcy has been a statutory vehicle for aid to those in financial need. Congress, through the Bankruptcy Code, has provided bankrupts with extensive protection from their creditors and a reasonable opportunity to rehabilitate not only for their benefit but for that of the public as well.

Although the IRS' argument that it has the statutory responsibility to collect all taxes from all taxpayers who may be liable for their payment is persuasive and indeed laudable [redacted] in most contexts, this Court believes that Congress has tempered that objective in the bankruptcy context, albeit in a limited fashion. The Court cannot agree with the IRS' contention that an act is involuntary simply because it occurs in a bankruptcy proceeding. Such an assertion flies in the face of Congressional concern for the rehabilitation of bankrupts, the dictionary definition of voluntary* and the consistent usage of the word

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* The word voluntary is defined in Webster's New Collegiate Dictionary as "1: proceeding from the will or from one's own choice or consent 2: unconstrained by interference: self-determining. . . ."

involuntary by practitioners and scholars to distinguish cases commenced pursuant to 11 U.S.C. § 303 from other cases.

Furthermore, the Court is mindful that the IRS had the opportunity to voice its concern with respect to the allocation issue at the time of the confirmation hearing but did not do so.[7] Although the Plan does not state specifically that all payments to the IRS will be credited first to the trust fund portion of the IRS claim until it is paid in full, the likelihood that the Trustee would seek such a designation was foreseeable. Indeed, both the Plan and Erco Liquidation Trust Agreement repeatedly emphasize the Trustee's broad powers to act for the benefit of creditors.[8] The Court is inclined, therefore, to view the Plan and the Trustee's authorized actions pursuant to it, including the designation of tax payments, as binding. As the court observed in *In re St. Louis Freight Lines, Inc.*, 45 B.R. 546 (Bankr. E.D. Mich. 1984), with respect to its jurisdiction to interpret the terms of a confirmed plan and the distribution of post-petition, pre-confirmation taxes:

> Section 1141(a) of the Code provides that confirmation binds the debtor, creditors and other parties in interest to the terms of the plan, even if a party has not accepted the plan. Case law has established the binding contractural nature of the plan. This rule has recently been used to bind the IRS and other taxing

[7] The IRS filed an objection to the debtors' Plan on August 1, 1984 on the grounds that the payment schedule would extend beyond the six years from the earliest day of assessment. It withdrew its objection in open court on the date of confirmation, September 9, 1984.

[8] For example, Article 5.1(h) of the Trust Agreement gives the Trustee the power to "amend this agreement in any manner whatever, provided that no such amendment shall permit the Trustee to engage in any activity prohibited hereunder and provided no such amendment shall limit the Rights of Beneficiaries."

> authorities to the terms of the debtor's confirmed plan. It is equally well established that an order confirming a plan is an appealable order that has *res judicata* effect *on all issues that could have been raised regarding the claim.* In other words, a party in interest . . . is bound by the plan when confirmed, even if the plan ultimately provides it with less than that to which it is otherwise legally entitled.

Id. at 551-52 (footnote omitted, citations omitted, emphasis supplied).

In view of the foregoing, the entire record of the case, and arguments of counsel whether or not mentioned herein, the Trustee's motion is allowed and the IRS is hereby ordered to apply tax payments under the Plan as designated by the Trustee.

By the Court,

/s/ JAMES N. GABRIEL
James N. Gabriel
Bankruptcy Judge

Dated at Boston in said District, this 7th day of April, 1986

APPENDIX E

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF RHODE ISLAND

BK No. 8500723

IN RE:

NEWPORT OFFSHORE, LTD., DEBTOR

DECISION AND ORDER OVERRULING THE OBJECTION BY THE INTERNAL REVENUE SERVICE TO ARTICLE III OF THE TRUSTEE'S PLAN OF REORGANIZATION

Before: Arthur N. Votolato, Jr., United States Bankruptcy Judge

Heard on the objection of the United States, on behalf of the Internal Revenue Service (IRS), to that portion of the Chapter 11 trustee's plan of reorganization which seeks to designate the manner in which IRS should apply plan payments to prepetition tax liabilities.[1]

Article III of the plan proposes to pay all Class Four claims, those of all the taxing authorities,[2] through "payment . . . of deferred cash payments over a period not in excess of six years after the date of assessment of such claim" pursuant to 11 U.S.C. § 1129(a)(9)(C). Interest on those claims will be paid according to the rate set forth in

[1] The order confirming the plan was signed on April 3, 1987, but this issue was reserved pending a ruling on the objection by IRS.

[2] Class Four claims consist of taxes owed to IRS, the State of Rhode Island, the Rhode Island Department of Employment Security, and the City of Newport.

26 U.S.C. § 6621. In addition, and in dispute, is that part of the plan which designates how the tax payments should be applied. Specifically, the plan provides that payments be credited first to the " 'trust fund'[3] portion of the . . . oldest taxes," second to the "interest on such trust fund portion of such taxes," and third, to "the oldest non-trust fund portion of the remaining tax obligations and the interest thereon." *See* Trustee's Plan of Reorganization, Article III at 7-8. IRS objects to the application of the tax payments as proposed,[4] and argues that it be permitted to apply the tax payments first to the non-trust fund taxes, in accordance with established IRS policy. *See Muntwyler v. United States*, 703 F.2d 1030, 1032 (7th Cir. 1983).

IRS and the trustee agree that if the tax payments are "voluntary," the debtor may designate how the payments should be applied. *See Muntwyler v. United States, supra*, at 1032. Conversely, if the payment is involuntary, the debtor does not have the power to direct application of the payments.

If it had its druthers, IRS would apply payments first to the non-trust fund taxes due, *see* IRS Memorandum in Support of the Objection to the Trustee's Plan at 5, essentially the opposite of how the trustee would direct the application of payments. Not surprisingly, the purpose of this IRS policy is to preserve the personal liability, created by 26 U.S.C. § 6672, of "[a]ny person required to collect,

[3] Trust fur [4] taxes are those required to be withheld pursuant to 26 U.S.C. § 7501 and which "shall be held to be a special fund in trust for the United States." They include the tax collected from employee wages, and the employee share of FICA tax. *Holcomb v. United States*, 622 F.2d 937, 938 (7th Cir. 1980).

[4] The other taxing authorities which did not object to the manner in which the plan directs payments to be applied to Class Four claims are bound by the order confirming the plan to apply them as directed. 11 U.S.C. § 1141(a).

truthfully account for, and pay over any tax imposed by this title." If IRS were unable to collect the full amount of trust taxes from the debtor, it then could proceed against the "responsible person," as defined by 26 U.S.C. § 6671(b), for the unpaid portion of those taxes. There is no personal liability for unpaid non-trust fund taxes. *See In re Mister Marvins, Inc.*, 48 B.R. 279, 280 (E.D. Mich. 1984). While IRS policy is to apply involuntary payments first to non-trust fund obligations, "there is no tax code provision regarding this subject." *In re Technical Knockout Graphics, Inc.*, 68 B.R. 463, 465 (9th Cir. B.A.P. 1986).

The most frequently cited definition of an involuntary payment, *Muntwyler v. United States, supra*, at 1032, is that of the Tax Court in *Amos v. Commissioner*, 47 T.C. 65, 69 (1966):

> An involuntary payment of Federal taxes means any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor.

However, in applying that definition the Seventh Circuit has stated that

> [t]he distinction between a voluntary and involuntary payment in *Amos* and all the other cases is not made on the basis of the presence of administrative action alone, but rather the presence of court action or administrative action resulting in an actual *seizure* of property or money, as in a levy. No authorities support the proposition that a payment is involuntary whenever an agency takes even the slightest action to collect taxes, such as filing a claim.

703 F.2d at 1033 (emphasis in the original).

In *Muntwyler*, which involved a non-judicial assignment for the benefit of creditors, the Seventh Circuit held that "merely filing a claim for back taxes" absent some form of "enforced collection measures" did not render the payment involuntary. *Id.* at 1033. IRS contends that the filing of a bankruptcy petition is sufficient "court action" under *Muntwyler* to render "any payment [of taxes] in a bankruptcy proceeding . . . *per se* involuntary." *See* IRS Memorandum at 15. Apparently, IRS draws this conclusion from note 2 of *Muntwyler*, 703 F.2d at 1034, where the court stated that "[t]he Government might have been correct in its claim if the corporation had been in bankruptcy, which it is not." However, the note continues "[a]n assignment for the benefit of creditors is an act of bankruptcy [under the 1898 Act] and presumably, any creditor, including the Government, could have proceeded to file an involuntary petition for bankruptcy based thereon." At best, it is unclear whether the Seventh Circuit meant that the requisite "court action" referred to filing a proof of claim, or to the filing of an involuntary bankruptcy petition, followed by a proof of claim. The difference between the two forms of "court action" is significant, and for our purposes is in fact dispositive.

The trustee disagrees with the *per se* test advanced by IRS, and reads *Muntwyler* in a different light. "In the instant matter, the IRS has merely filed a proof of claim. There has been no court action with respect to the IRS' claim, let alone 'court action [or administrative action][3] resulting in an actual seizure of money or property as in a levy' " (citing *Muntwyler, supra*, at 1033). *See* Trustee's Memorandum at 7. The trustee construes the phrase "resulting in an actual *seizure*" to apply to court action as

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[3] The trustee's memorandum omitted the bracketed portion of the quotation.

well as administrative action.[6] In any event, the trustee argues that some type of " 'enforced collection measure,' " *Muntwyler, supra,* at 1033, beyond the filing of a proof of claim, is necessary to qualify as "involuntary," payments made under a Chapter 11 plan of reorganization.

Several courts have already faced the issue of determining voluntary versus involuntary payments, within the context of a bankruptcy case. The trustee's position that payments to IRS pursuant to a Chapter 11 plan are voluntary is supported by the following: *In re Technical Knockout Graphics, Inc., supra*; *In re Energy Resources Co., Inc.*, 59 B.R. 702 (Bankr. D. Mass. 1986); *In re Lifescape, Inc.*, 54 B.R. 526 (Bankr. D. Colo. 1985); *In re A & B Heating & Air Conditioning, Inc.*, 53 B.R. 54 (Bankr. M.D. Fla. 1985); *In re Franklin Press, Inc.*, 52 B.R. 151 (Bankr. S.D. Fla. 1985). On the other side of the coin, although none have phrased their conclusions as strongly as a *per se* rule, the following courts support the IRS position that payments of tax claims in bankruptcy are involuntary: *In re Mister Marvins, Inc., supra*; *In re Frost*, 47 B.R. 961 (D. Kan. 1985); *Matter of Avildsen Tools & Machine, Inc.*, 40 B.R. 253 (N.D. Ill. 1984); *aff'd* 794 F.2d 1248 (7th Cir. 1986); *In re Vincent-McCall Co.*, 68-2 USTC (CCH) ¶ 9591 (E.D. Wisc. 1968) (Act case, referee's opinion). In affirming the district court in *Avildsen Tools*, however, the Seventh Circuit stated "[w]e do not have to decide whether a payment for delinquent pre-bankruptcy petition taxes made to the government is voluntary or involuntary" since the debtor had breached

[6] IRS reads the language more restrictively and, apparently, feels that the qualifier "resulting in an actual seizure," applies only to "administrative action," and that *any* "court action" within the bankruptcy case, even if it involves only the filing of a proof of claim, renders the payment involuntary.

its agreement as to how the tax payments would be applied. 794 F.2d at 1252. Since the debtor breached its agreement with IRS, the government was no longer bound as to how the payments would be applied. *Id.* at 1254. It appears, therefore, that no Court of Appeals has squarely decided the issue of whether payments under a plan pursuant to § 1129 are voluntary or involuntary.

In re B & P Enterprises, Inc., 67 B.R. 179 (Bankr. W.D. Tenn. 1986) reaches a more flexible conclusion about midway between the positions taken by the parties. There, the bankruptcy court rejected both the IRS *per se* rule, and any ruling wherein the trustee or debtor-in-possession could unilaterally direct the allocation of payments under a confirmed plan to the trust fund portion of the IRS claim. *Id.* at 183. Instead, the court held that such questions should be decided on a case-by-case basis, and set out what it considered were the relevant factors in the analysis.[7] *Id.* at 184.

We feel that the Court's approach in *In re B & P Enterprises, Inc., supra*, is more workable than either of the rigid approaches advocated by the parties. Taking full advantage of our new found flexibility, and considering the "totality of the facts and circumstances," *id.* at 184, of this case, we conclude that the trustee should be allowed to direct the application of payments to IRS as set forth in the plan. Except for filing a proof of claim, the only involvement of IRS in any court action in this case has been

[7] The factors include: (1) the history of the debtor; (2) whether IRS has taken any pre-bankruptcy collection or "enforced collection measures" against the debtor or the appropriate responsible person; (3) the nature of the Chapter 11 plan (*e.g.*, reorganization or liquidation); (4) the presence, nature and extent of administrative and/or court action; (5) existence of exceptional or special circumstances warranting allocation provided by the plan. *In re B & P Enterprises, supra,* at 184.

to press the objection to confirmation. IRS has not (nor had it previously) taken any "enforced collection measures." The plan calls for reorganization as a going concern, rather than liquidation of assets and conversion to Chapter 7. Most importantly, however, the funding for this plan comes from a third party, Allied Marine Associates. Other courts have held that third-party funding alone is sufficient to render payments to IRS voluntary. *See In re Energy Resources Co., Inc., supra*; *In re Franklin Press, Inc., supra.* In the real world of business reorganization, most successful Chapter 11 plans depend, in part, at least, on the infusion of funds provided by outside investors. The inflexible application of the *per se* rule advanced by IRS would remove the initiative of former principals to seek outside investors, who voluntarily inject needed cash into the estate, and would, as a consequence, either inhibit or eliminate altogether the likelihood of a viable Chapter 11 plan. If the purpose of Chapter 11 is to rehabilitate rather than liquidate debtors, the Court's role in this process is greatly enhanced by allowing the judge to review each case on its own merits and to confirm those which meet the requirements of § 1129. Using that approach in this case, we conclude that the third party payments constitute sufficient "special circumstances," *In re B & P Enterprises, Inc., supra,* at 184, to allow the trustee to allocate such payments first, to the trust fund portions of the debtor's tax liabilities and, thereafter, to the non-trust fund amounts.

IRS expends considerable argument on two points which deserve comment. IRS argues that allowing the allocation of payments to trust fund taxes unfairly benefits the "responsible person" as defined by the Internal Revenue Code, and shifts the risk of non-payment of the tax liability to the government. In this case, however, IRS fails to identify the responsible person to whom it

ascribes such remarkable influence over the plan proposed by the trustee.[8] That person, who we surmise (since IRS has not told us) might be the "responsible person," a mid-level financial employee, is neither a principal of the debtor nor a major stockholder, and does not directly benefit from the plan (except perhaps for payment of a priority wage claim, along with all other employees). The contention that the sole purpose of this part of the plan is to benefit Kevin Walsh, the controller, is a theoretical argument with no factual or practical supprt. IRS also argues that the plan could likely fail as soon as the trust fund tax liabilities are paid, and the responsible person relieved of any potential assessment under 26 U.S.C. § 6672. As we view it, a plan likely to fail in the manner IRS describes would not be confirmable under 11 U.S.C. § 1129(a)(11) ("[c]onfirmation of the plan is not likely to be followed by the liquidation, or need of further financial reorganization of the debtor . . . unless such liquidation or reorganization is proposed in the plan"). We have already found that the trustee's plan complies with the requirements of §1129, that rehabilitation is likely, and that failure (either prior or subsequent to payment of trust fund taxes) is not the expected route for this debtor.

Therefore, for the foregoing reasons, Article III of the trustee's plan of reorganization regarding the treatment of Class Four tax claims is confirmed, and IRS is ordered to apply the payments as designated in the plan.

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[8] IRS does not argue that the trustee is the "responsible person" seeking to avoid personal liability under the plan.

Dated at Providence, Rhode Island this 14th day of July, 1987.

/s/ ARTHUR N. VOTOLATO, JR.
Arthur N. Votolato, Jr.
Bankruptcy Judge

APPENDIX F

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 87-1896

IN RE: ENERGY RESOURCES CO., INC., DEBTOR

INTERNAL REVENUE SERVICE, PLAINTIFF, APPELLANT

v.

ENERGY RESOURCES, CO., INC., DEFENDANT, APPELLEE

Entered March 31, 1989

JUDGMENT

This cause came on to be heard on appeal from the United States District Court for the District of Massachusetts, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The judgment of the district court is affirmed.

By the Court:

/s/ FRANCIS P. SCIGLIANO
Francis P. Scigliano
Clerk

APPENDIX G

UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

No. 88-1175

IN RE: NEWPORT OFFSHORE, LTD., DEBTOR

UNITED STATES OF AMERICA, PLAINTIFF, APPELLEE

v.

NEWPORT OFFSHORE, LTD., DEFENDANT, APPELLANT

Entered March 31, 1989

JUDGMENT

This cause came on to be heard on appeal from the United States District Court for the District of Rhode Island, and was argued by counsel.

Upon consideration whereof, It is now here ordered, adjudged and decreed as follows: The judgment of the district court is reversed.

By the Court:

/s/ FRANCIS P. SCIGLLANO

Francis P. Scigllano
Clerk

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